E. Witherell

BANKING PRACTICE

A TEXTBOOK FOR COLLEGES AND SCHOOLS
OF BUSINESS ADMINISTRATION

and electives

By

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Third Printing

NEW YORK

THE RONALD PRESS COMPANY

1922

PREFACE

The purpose of this book is to furnish a textbook dealing with banking technique, organized from the standpoint of functions rather than of bank departments. This arrangement has been followed to enable the student to get the administrative point of view together with an understanding of practical banking operations. He can do this from the standpoint of functions where he would find it almost impossible to think clearly in terms of department organization and details of operation regarding which he really has no conceptual background.

Such an arrangement fits the book both to the pedagogical requirements of the teacher and to the background of information which the student really possesses.

The basis of the present volume is found in "Practical Bank Operation," prepared under the direction of the National City Bank of New York by Mr. L. H. Langston, and published by the Ronald Press Company. It represents, in fact, a reworking of the material there given descriptive of actual banking technique, with the purpose of suiting it to class use as a text. The aim of the authors has been to enable students to make full use of this unique cross-section of a great city bank of today, by indicating for him the typical features of bank procedure as they present themselves in a working organization.

To render the technical detail more readily intelligible to the student, extensive changes have been made in the arrangement and form of presentation, and much new material of an explanatory nature has been introduced. For such changes and additions, of course, the National City Bank is in no degree responsible.

In the text as so worked out the authors have sought to explain the actual procedure in the handling of banking transactions, and

to remove the mystery which for the layman enshrouds banking terminology. At the same time, they have sought to set forth clearly and sufficiently the theory underlying all of the operations described, so that the student who thoroughly masters the book, if confronted with the task of putting through any banking transaction, will be in a position, if necessary, to reason out for himself a satisfactory method of procedure.

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New York City,
January 25, 1921.

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BANKING PRACTICE

CHAPTER I

ORGANIZING A BANK

Methods of Incorporation and Organization.—From the standpoint of organization there are three types of banking institutions: private banks, state banks, and national banks. Those in the first group are unincorporated, those in the second and third are incorporated.

A corporation is an association of persons banded together to carry on a specified business, obtaining for this purpose, by means of a charter, certain rights and advantages which cannot otherwise be enjoyed. The most important of these advantages are a limitation of the members' liability for the debts of the corporation, a continuity of existence not affected by the death or withdrawal of any member of the group, and the grant of a legal personality to the association, thus conferring upon it the right to buy, sell, and hold property, with the power to sue and the liability to be sued in the courts. The capital stock of a corporation is divided into shares of uniform value which are distributed among the proprietors in proportion to the sums they invest and which may be sold and transferred at the will of the owner.

Private Banks.—Private or unincorporated banks operate without charter or special authority from a governmental body and in this respect they are similar to any other private business. There are certain disadvantages inherent in this method of bank organization. First, the disadvantages of individual proprietorship as compared with corporate organization apply to banking no less than to other lines of business. Secondly, since such institutions are not incorporated they have not been subject to inspection by public officials, nor have they been compelled to

render reports of their business to public authorities. Hence there is perhaps an element of secrecy about their resources and operations. The tendency in recent years, therefore, has been to prohibit the performance of banking functions except under state or federal supervision, and, in those states in which private banks are permitted to operate, to require them to submit to a degree of regulation and supervision by state authority.

Banks under State Supervision.—State banks are institutions authorized by state laws to carry on the banking business. Though each state enacts its own laws to regulate corporations desiring to engage in banking, there is considerable similarity in the legal banking provisions of all states.

Two methods of authorizing persons to engage in the banking business have been in use in this country. In the early period charters were granted by special acts of the various state legislatures. The persons desiring to engage in banking had their representative introduce a bill which authorized them to begin business and specified the conditions under which the business was to be carried on. The disadvantages of this method are obvious. Charters were granted to those associations with most political influence and power and in some instances, it has been charged, to those who used part of their financial resources to influence the legislatures; whereas those groups whose members were politically opposed to the party in power seldom obtained recognition. The granting of special charters has therefore been superseded by a second method—the adoption of general incorporation laws. These laws specify the conditions that must be met and the manner in which the banking business must be carried on. Any group of individuals which complies with the preliminary requirements and subscribes to the rules for the conduct of the business may now obtain a charter to engage in banking.

Banks under National Control.—Banks under national control have received their charters from the federal government, and are required to use the word "National" in their title. The National Bank Act of 1863 authorizes persons in any part of the country to make application to the federal government for permission to carry on a banking business under the terms granted by that act. The preliminary conditions to be met and the restrictions on operation are uniform for all institutions calling themselves national banks. From the standpoint of numbers the state-chartered institutions far exceed the national associations. But from the standpoint of resources and financial influence the national bank system is the more important.

Need for Government Regulation.—There are two strong reasons for the control of the banking business by government authority, whether state or national. The first of these reasons is safety. Bankers occupy a position of great trust. Millions of people throughout the country entrust a large portion of their wealth to the care and custody of banks. The very word "bank" connotes security in the minds of many people, and therefore almost any group of persons who may open an office which they call a bank will, through the confidence aroused by the name, attract deposits from people seeking a place of security for surplus funds. It is essential, therefore, that public confidence in institutions called banks be preserved so that people will be encouraged to deposit their savings in places where the money will be used wisely, thus counteracting the tendency to hoard money which will be exposed to the hazards of theft, fire, and foolish speculation. Hence, not only as a matter of justice but also as a wise social policy, banks should be subject to such control as will protect the savings entrusted to their care. A bank failure exercises a restraining and blighting influence on the economic life of a community for years after its occurrence. Unfortunately persons who occupy positions of trust are not always absolutely

honest and uniformly wise. To the customers of a bank that has failed, honest mistakes are just as costly as purposeful dishonesty. The chief reason, then, for state and federal regulation of the banking business is to insure its honest and reasonably efficient conduct.

The Social Importance of Public Supervision.—The second reason or justification for government supervision rests on the theory that banking is a quasi-public or public service operation. The bank is the center about which revolves all other business. It is safe to say that no business in this country can be carried on without banking connections. The bank may be used merely as a depositary and as a convenient agent to transfer funds from one place to another, or it may be relied upon to supply credit or to furnish business and financial counsel. As a well-known Austrian economist has said, the banker is the modern entrepreneur, who determines in a large measure the course business shall take.

Since a modern bank is so intimately related to all forms of economic activity and, by the granting or withholding of credit, has the power to direct the course and progress of industry, it is important to supervise these institutions and see that their great power is not abused. This supervision devolves upon the Comptroller of the Currency and the various state bank superintendents. Banks, like any other business, are organized by private individuals for the purpose of making a profit. It is conceivable that in a particular instance the policy which insures a maximum profit to the banker may not promote the general welfare. It is likewise possible for groups of individuals to secure control of the powerful financial machinery provided by banks and use it for their own selfish purposes. One of the purposes of bank regulation is to prevent the improper use of this financial machinery.

Preliminaries to Organization—Selection of Stockholders.—In the practical work of organizing a bank, certain preliminary

matters must be disposed of before an application is made for a charter. The first of these is the selection of the prospective stockholders. Though the idea prevails that bank shares are offered for sale to the public, like the shares of other corporations, this is not true in all cases. In the organization of the majority of banks special attention is given to the selection of persons who are to be solicited to buy shares, because it is expected that such persons, by reason of their social business standing, will be of value to the new institution.

Determination of Kind of Bank to be Established.—A second preliminary step is the determination of the kind of bank to be established. As before stated, the chartered banks are divided into two main groups: national and state banks. State banks include commercial banks, savings banks, and trust companies. While all such banks are chartered by the state, each type has its peculiar functions and its special advantages. The kind of bank to be organized is, of course, largely determined by the nature of the community. For example, if a new bank were to be established in a town of 1,000 people, it might be disadvantageous if not impossible to secure a capital of $25,000, the minimum amount for the establishment of a national bank. If this requirement precluded the organization of a national bank in a small community, the alternative would be to organize under the state charter provided the state laws allowed banks to be established with the amount of capital available. Before the recent amendments to the National Bank Act made it possible for national banks to lend money on real estate security, it would have been questionable policy in many cases to organize a national bank in an agricultural community where loans are largely based on farm mortgages. Inasmuch as national banks were forbidden to loan money on real estate security, the chief source of profit for a rural national bank was cut off—a handicap not encountered by a state-chartered institution.

Other privileges may also be available to banks of one type and not open to banks of another type; or legal regulations may impose serious handicaps on certain kinds of banking institutions. Thus, some states may permit a lower capitalization for state banks than is required by federal law for national banks, but the reserve requirements may be higher for the state banks. Or savings banks may have the privilege of requiring 30 or 60 days' notice of intent to withdraw money on deposit with them, whereas the commercial banks are required to meet withdrawals on demand. On the other hand, savings banks may be and often are more strictly limited as to their range of investment than are commercial banks. Trust companies, the characteristic functions of which are to act as guardian, administrator, executor, and trustee for individuals, and as fiscal agents for large corporations, cannot usually find enough business purely of this nature to make it worth while for them to operate strictly as trust companies anywhere except in the larger centers. In smaller communities such companies commonly do a commercial banking business in addition to their trust work. Thus, the business habits of a community, the kind of banking competition to be faced, and the relative advantages of incorporation under different laws, are matters that must be considered before an application is made for a charter.

The Amount of the Capital.—A third step preliminary to the application for a charter is the determination of the amount of the new bank's capital. Within certain specified limits a bank can be capitalized at any figure desired. In the case of state banks the capital requirements vary with the laws in each state. In most states no banks are chartered with a capital of less than $10,000, and in many states the minimum is higher. It is the general practice to base the minimum capital on population, and the requirements for national banks are uniform throughout the country. No national bank may be established with a smaller

capital than $25,000, and such minimum prevails only in places with a population of 3,000 or less. With a population of more than 3,000 and less than 6,000 the minimum capital is $50,000; of more than 6,000 and less than 50,000 the minimum is $100,000; and for all places having more than 50,000 inhabitants, the minimum is $200,000.

A bank may capitalize at whatever figure seems advantageous above the minimum requirements. In determining the amount three considerations prevail: first, the bank desires the capital necessary to handle its business in a way to meet the competition of existing banks; secondly, the capital should be limited to an amount that can be conveniently and safely invested in operations in its community; and thirdly, the amount should be a sum that can be raised in the community.

Method of Applying for a Charter.—After these preliminaries have been completed, the organizers of a bank can apply for a charter. The requirements of all states conform fairly closely with the procedure followed in obtaining a charter under the National Bank Act, and therefore it will be sufficiently informative to outline the manner in which a charter for a national bank is obtained.

The application for a national charter to carry on the banking business must be made to the Comptroller of the Currency in Washington. At least five natural persons make application as incorporators. The term "natural person" discriminates against corporations or joint-stock companies. While, however, corporations may not be incorporators, there is nothing to prevent them from holding a bank's stock if such ownership is not prohibited by the state laws under which the bank is incorporated.

Although not legally necessary, it is frequently the practice, on the organization of a bank, to circulate a subscription paper in special form suggested by the Comptroller. Such a paper sets forth the fact that the signers have subscribed for the number of

shares indicated therein and intend to apply for a charter under the laws of the United States for the right to establish a bank with a capital stock of a specified amount. Each shareholder signs the paper giving his address, occupation, his net financial worth, and the number of his shares. Every shareholder is assumed to be worth at least double the amount of his subscription, for the reason that shareholders in national banks (and in the banks chartered by many states as well) are liable in case of the bank's insolvency for an additional amount equal to their subscription.

The Application Form—Contents.—At least five shareholders must sign the application for a charter to the Comptroller of the Currency, and the application must be indorsed by three prominent persons, preferably public officials. The document states the intention of the signatories to organize a national bank under the title specified, and designates the location, the amount of the capital stock, and the population of the town where the bank is to be located; it requests that the title applied for be reserved for a period of 60 days and that organization blanks and instructions be sent to the person whose name is indicated. Space is left on the blank form in which to inform the Comptroller if any of the applicants have been previously connected with a banking institution, and, if so, its name, for what period, and in what capacity.

Before giving his approval to any application, the Comptroller publishes the fact that application has been made for a charter for such bank, and he refers each case to a member of Congress from the district in which the bank proposes to locate. He also refers the application to the local national bank examiner and the local state bank supervisor for additional information as to the standing of the applicants, the need for a new bank in the locality, and the prospects of success. He seeks to assure himself that the demand for the new institution emanates from the business in-

terests of the community and not from outside promoters who are desirous merely of obtaining a profit from the work of organization. In considering the title of the bank, the Comptroller seeks to prevent duplication and confusion. The title "First National Bank," for example, will not be granted to any other bank if there is a national bank, no matter what its name, already in existence in the community. Furthermore, the use of a title similar to that of any other state or national bank in the community is not permitted.

Organization Papers.—After the title has been approved, the Comptroller forwards a number of blank organization papers with instructions for their use. These papers include the following:

1. Articles of association, or incorporation.
2. The organization certificate.
3. A blank for the oaths of the directors.
4. A blank for the signature of officers.
5. Model by-laws.
6. A certificate as to payment of capital stock.
7. An order for notes for circulation purposes.

Each of these documents will be briefly described below.

Articles of Incorporation.—The articles of incorporation give information regarding the following items:

1. The title of the banking association.
2. The town where the banking office is to be located.
3. The number of directors to be chosen and the place of first meeting for their election.
4. The provision made for regular annual meetings.
5. A statement as to the total capital stock and number of shares, with the provision for increasing the capital at any subsequent time.
6. An outline of the powers of directors.

7. A statement as to the life tenure of the association.
8. The provision made for the amendment of the articles.

These articles of association must be signed by at least five natural persons.

Organization Certificate.—The next important blank to be filled out is the organization certificate. This contains information regarding:

1. The name of the association.
2. The place where the operations of discount and deposit are to be carried on, including the state, territory, or district, and the county, city, town or village.
3. The amount of the capital stock and the number of shares.
4. The names and places of residence of all shareholders and the number of shares held by each.
5. The fact that the certificate is made to enable the signers to avail themselves of the advantages of the National Bank Act.

Every share must be allotted when the organization certificate is executed, and the certificate must be signed by the same persons who sign the articles of association, and must be acknowledged before a judge or notary public. After the articles of association and the organization certificate have been executed and filed with the Comptroller, the association becomes a corporate body from the date of the execution of the organization certificate.

Directors' Oath of Office.—A third blank to be filled out contains the oaths of the directors. Each director makes oath that he will administer, diligently and honestly, the affairs of the bank which are entrusted to him, that he is the owner in good faith and in his own right of the required number of shares, and that these shares are not hypothecated or pledged in any manner as security for debt.

Signatures of Officers.—The articles of association may designate merely the time and place for electing the first board of directors, or the directors may be appointed and their names indicated in the articles. Along with these papers must be sent the blank which contains the official signatures of the officers. Space is provided for the signature of each officer, the date of his election or appointment, and the name of his predecessor.

Model By-Laws.—The Comptroller sends to each new bank copies of model by-laws. The bank may accept these, modifying them to suit its wishes, or may draw up its own form of by-laws, so long as it includes one or two provisions which the Comptroller insists be found in all such by-laws. As a matter of practice most banks adopt the by-laws already prepared by the Comptroller.

Stock Payment Certificate.—Another official paper connected with the organization is a certificate declaring that the legal requirement has been met for the payment of 50 per cent of the capital stock before beginning business, and that all other provisions necessarily antecedent to beginning business have been complied with. After the organization papers have been approved, an examination at the expense of the bank is made to satisfy the Comptroller that all legal requirements have been met. If the examination is satisfactory, a certificate of authority to begin business is forwarded to the bank. This certificate must be printed for 60 days in a newspaper published in the city or county in which the bank is located.

Bank Note Order Blank.—The final official document sent to the association by the Comptroller is the order blank for circulating notes. Formerly every national bank was compelled to buy a specified quantity of government bonds, the securities serving as the basis for its own note issues. This compulsory purchase of bonds that pay only 2 per cent interest made it neces-

sary for the bank to secure a larger return on the money thus invested, by taking out circulation and lending such circulating notes at the market rate of interest.

Since the passage of the Federal Reserve Act, it is no longer necessary for a bank to buy government bonds. If, however, it wishes to make use of the circulation privilege, the same requirement still prevails, namely, that bonds must be purchased and deposited with the Treasurer of the United States. Notes may then be issued up to either the par value or the market value of the bonds owned, the limit being the lower of the two values.

If a bank desires to take out circulation, it may deposit bonds for this purpose to an amount not exceeding its capital stock. In any case the minimum amount of bonds that may be purchased if the bank wishes to exercise the circulation privilege, is specified. If the amount of the capital stock is $150,000 or less, bonds must be purchased to the extent of one-fourth of the capital; if the capital is more than $150,000, bonds must be purchased to the extent of at least $50,000. If the new bank fills out the order for notes, it specifies the denomination of notes it desires, and agrees to pay the cost of preparing the dies for engraving. After the notes have been printed they are forwarded to the bank to be signed by the president and cashier before their issuance. It has been held that if a bank is willing to assume responsibility for the redemption of its notes, it is immaterial whether they be actually signed by the officers or have the signatures merely lithographed or stamped thereon with a rubber stamp.

In addition to the above requirements, every national bank must, before commencing business, subscribe an amount equal to 6 per cent of its total capital and surplus to the stock of the federal reserve bank of its district. On this it receives cumulative dividends of 6 per cent a year.

Issuance and Transfer of Stock.—The association is now prepared to begin business. Its capital stock may be increased

at any time and to any amount if authorized by two-thirds of the shares of the bank and with the approval of the Comptroller. The shares may be paid for in instalments, the requirement being that at least 50 per cent of each shareholder's subscription must be paid in before the bank begins business, the balance being payable 10 per cent monthly. After the first instalment is paid, each shareholder is given a temporary receipt; and when payment in full has been completed, a certificate indicating the number of shares purchased is issued. Records of the certificates issued are kept in the stock certificate book and on the stock transfer ledger. Great care is taken to see that no unauthorized certificate is issued, and the total par value of certificates outstanding must never exceed the total amount of the capital stock.

When the stockholder desires to transfer his shares to another person, his certificate is surrendered, canceled, and attached to the stub to which it belongs in the stock certificate book, and a new certificate or certificates for the same total number of shares is issued. The stub bearing the number corresponding to that of the new certificate issued is filled out as a record of the transaction.

Privileges Granted by the Charter.—The completion of the formalities described above enables the new bank to:

1. To adopt and use a corporate seal.
2. To have a corporate life of twenty years.
3. To make contracts.
4. To sue and be sued.
5. To elect and appoint directors and officers.
6. To adopt by-laws.
7. To exercise such incidental powers and functions as are necessary to carry on the banking business.

The incidental powers just mentioned include: discounting promissory notes, drafts, bills of exchange, and other evidence of debt; receiving deposits; buying and selling exchange, coin, and bullion; loaning money on personal security; obtaining and cir-

culating notes; acting, if permitted by the Federal Reserve Board, as trustee, executor, administrator, or registrar of stock and bonds; and establishing foreign branches. The last function is permitted only to a bank possessing a capital and surplus of $1,000,000 or more, after the consent of the Federal Reserve Board has been obtained. Under the same conditions, a bank may also invest in the stock of corporations engaged in foreign banking, provided the sum invested does not exceed 10 per cent of its paid-in capital and surplus. The Federal Reserve Act also authorizes national banks to accept drafts or bills of exchange drawn upon them under certain conditions, provided these drafts are based upon transactions involving the exportation or importation of goods, or are drawn to create dollar exchange.

CHAPTER II

MANAGING THE BANK

The Bank Managers.—The management of a bank may be the more conveniently discussed from two points of view: that of its personnel or machinery of management, and that of its problems of management. The managerial machinery consists of the directors, the officers, and the heads of departments and divisions.

Theoretically, though not always in actual practice, the management of a bank is vested in its owners—in the case of a state or national bank—the stockholders. If things do not go as well as the stockholders desire, they may assume control and choose a new group of directors and officials. However, in the majority of cases the management of the bank is left entirely in the hands of the directors and the officials chosen by them. The directors are the representatives of the shareholders by and from whom they are chosen. They are elected at the annual meeting of the stockholders which must be held some time during January. The Comptroller of the Currency has expressed his preference for the second Tuesday in January.

Number and Qualifications of Directors.—National banks are required to have a board of not less than five members, but no maximum number is fixed. The by-laws must specify the maximum and minimum numbers. In the larger cities it is preferable to have a larger number for the purposes of distributing the burden of administration, of securing a representative board, and of enlarging the possibilities of obtaining business by means of the close personal interest devoted to the bank's welfare by a considerable number of men. Directors are elected

for a term of one year and until their successors are elected and qualified.

Every director of a national bank must, during his whole term of office, be a citizen of the United States. Three-fourths or more of the members of the board must have resided for at least one year immediately preceding their election in the state, territory, or district in which the bank is located, and they must be residents therein during their continuance in office. These residential and citizenship qualifications insure local control of the bank.

Every director must possess in his own right and free from debt at least ten shares of stock of the bank unless the capital does not exceed $25,000, in which case he must own not less than five shares. Any director who ceases to be the owner of the required number of shares or who becomes disqualified in any other manner, automatically vacates his office. No person who holds stock in a merely representative capacity as trustee, executor, administrator, or guardian can be a director. The purpose of these property qualifications is to give the directors a personal interest in the successful management of the bank.

Interlocking Directorates.—Formerly it was legal for wealthy and powerful financiers to serve on the boards of a number of banks. From the standpoint alike of the bank and of the public, this custom had some advantages and disadvantages. The chief advantage was that each of such banks had the benefit of the judgment, experience, and wide observation of men who were closely in touch with business affairs on a large scale. The chief disadvantage was the danger that men in a position to influence the actions of a number of important financial institutions might use their power for their own advantage and to the detriment of others. As a result of the widespread agitation against trusts and similar large business combinations, legislation has been enacted which seeks to prevent the danger of the domination of a large number of banks by a few individuals.

Restrictions Imposed by Clayton Act.—The Clayton Act of 1914 provides that no person shall be at the same time a director or other officer or employee of more than one member bank of the federal reserve system if such a bank has deposits, capital, surplus, and undivided profits aggregating more than $5,000,000. No private banker or person who is a director in any state bank having deposits, capital, surplus, and undivided profits aggregating more than $5,000,000, is eligible to be a director in any member bank of the system. No member bank in a city of more than 200,000 inhabitants may have as a director or other officer or employee any private banker or any director or other officer or employee of any other bank, banking association, or trust company located in the same place, with the following exceptions: first, this prohibition does not apply to mutual savings banks without capital stock; secondly, a director or other officer or employee of such bank, banking association, or trust company may be a director or other officer or employee of not more than one other bank or trust company organized under federal or state law, where the entire capital stock of one bank is owned by the stockholders of the other bank; thirdly, a director of class A of the federal reserve bank may be an officer or director in one member bank.

Modifications of the Clayton Act.—The Clayton Act was modified by the Kern amendment in 1916. This permits any officer, director, or employee of any member bank, or a class A director of a federal reserve bank, if he first obtains the consent of the Federal Reserve Board, to be an officer, director, or employee in not more than two other banks, banking associations, or trust companies whether they are national or state institutions, provided that such other bank, banking association, or trust company is not in substantial competition with such member bank. The Federal Reserve Board is authorized to grant or withhold such consent, and it possesses the authority to define what constitutes substantial competition.

Another amendment permits any director or other officer, agent, or employee of any member bank, with the consent of the Federal Reserve Board, to be a director or other officer or employee of any bank or corporation chartered under federal or state law and personally engaged in international or foreign banking, or banking in any dependency or insular possession of the United States, in the capital stock of which bank or corporation the member bank has invested as allowed by law.

The Edge Act repeats the substance of this amendment in that it permits officers, directors, and employees of member banks to become affiliated, given the consent of the Federal Reserve Board, with a corporation authorized under the act, provided the member bank is itself a stockholder in such corporation. The law was still further amended in 1917 when it was provided that state banks becoming members of the federal reserve system may continue to exercise their full charter and statutory rights as state banks or trust companies. This amendment exempts such banks from certain provisions of the Clayton Act.

Directors' Authority and Compensation.—A director is not an agent of the bank. He cannot act separately and independently of his fellow members; only when the board is duly convened and acting as a unit can his wishes influence its action. A majority of the board usually constitutes a quorum, but the number is determined specifically by the charter provisions. The board is presumed to meet at frequent intervals to determine the bank's policy. The Comptroller requires that meetings be held at least once a month, though in most banks meetings are held weekly or even more frequently.

While directors serve nominally without salary, it is customary to give them a fee for each meeting attended. This fee is intended to be in partial compensation for the loss of time from their own businesses. No director, officer, or employee of a bank may be the beneficiary of, or receive directly or indirectly, any

fee, commission, gift, or other consideration for or in connection with any business of the bank, other than the usual reasonable salary or director's fee.

The Selection and Functions of the Board.—In choosing directors various factors are considered. The largest stockholders may be elected on the assumption that large shareholdings will induce such men to take a keen interest in the success of the bank. Men of influence in a community or of large capital and important business connections are frequently elected because it is assumed that they will bring the bank considerable business. Above all it is important that the directors be men of clean financial record and that they be endowed with conservative business sense and sound judgment.

The board exercises general control over all the affairs of the bank, and with a few restrictions can do anything the corporation can do under its charter. The functions of directors are largely determined by the needs in each case. Members of the board are presumed to know what is done in the bank and the method of carrying on the business. They may appoint agents and give them sufficient power to execute the will of the board and to carry on the ordinary transactions of business. Any such delegation of power does not divest the directors of their responsibility; they may be held for losses arising through the acts of officers and employees who have not acted in good faith or with ordinary diligence.

Liability of Directors.—Directors are regarded as trustees for the stockholders, depositors, and note-holders. The courts have insisted that the actions of the directors be free from suspicion and blame, and have prohibited them from acting in cases where self-interest may bias them. A director may not acquire any interest adverse to the bank of which he is a director; nor may he secure by means of his position any advantage not open to the

other stockholders. If, for example, he applies for a loan he must make application just as any other borrower, and he must not vote on the approval of his application.

Directors can use the funds and property of the bank only for proper banking functions and for the bank's advantage in the best manner that their knowledge and ability can devise. They cannot vote to contribute to charities or to make gifts. They are liable for losses to stockholders or creditors or both if incurred, because they as directors failed to manage the bank according to the charter and in good faith. They are not liable for losses arising through frauds of officers, provided they themselves have not been grossly negligent in the selection and supervision of the bank's officials.

In keeping with their responsibility, the directors of a bank exercise more personal control over their corporation than is usually exercised by the directors in any other type of business organization. The Comptroller of the Currency has from time to time made a special effort to have the directors actually direct the affairs of their bank. In the larger banks every loan is scrutinized by the whole board or by a special committee appointed for that purpose.

The Officers of the Bank.—The officers of a bank vary from a president, vice-president, and cashier in small banks, to a much greater number in the larger banks. For example, a large New York bank may have a chairman of the board of directors; a president; several executive managers, one of whom is designated general executive manager; a number of vice-presidents; a comptroller, cashier, and a number of assistant vice-presidents and assistant cashiers.

The President—His Work and Responsibility.—The president of a national bank is chosen by the board of directors from its members. His primary function is to preside over the meet-

ings of the board, but in addition he frequently participates in the active management of the bank. When the chairman of the board and the president are distinct persons, the former performs the duty of presiding over the board meetings, while the latter serves as the manager of the bank. So far as managerial powers go, the position of the president is one of indefinite responsibility rather than of definite limits. He is generally the court of last resort in determining matters of policy when the board of directors is not in session, and because of his intimate contact with the bank's affairs his opinion and judgment frequently determine the line of action of the board.

In very large banks the work and responsibility of administration are so heavy that it would be impossible or undesirable for one man to assume the whole burden. Therefore a number of executive managers are sometimes chosen from among the vice-presidents, and one of them may be designated general executive manager. To these men of wide experience and close knowledge of banking technique are delegated the problems arising in connection with the actual operation of the bank.

Duties of the Vice-Presidents, etc.—The vice-presidents in a large bank are usually men who are experts in banking or in some other lines of business, and their duties consist in handling administrative problems arising within their particular fields. For administrative purposes, it is a common practice to divide the business of the bank into portions, each of which is under the control of a vice-president. In a certain large bank, for example, the unit of administration is the territory. The domestic territory is divided on the basis of the federal reserve districts, and the foreign territory according to groupings of contiguous countries. To maintain close personal touch with customers, all the business of a particular territory is administered by a vice-president assisted by the necessary number of assistant vice-presidents and assistant cashiers. Each vice-president is responsible for

maintaining and extending the business in his territory. He controls the resident representatives of the bank, in the domestic field, and through them increases its business and obtains credit information. In the foreign territory he controls the branches and agencies of the bank. Subject to review by a general meeting of the officers and directors, each vice-president passes upon all applications for loans and for lines of credit arising in his territory.

In addition to the vice-presidents in charge of territories, there are other vice-presidents, assistant vice-presidents, and assistant cashiers who are charged with the administration of certain operating departments, as for example, the foreign exchange department, the credit department, the trust and publicity departments.

The Comptroller; the Cashier.—In banks where a distinction is made between the comptroller and the cashier, the comptroller is usually in charge of the accounting and auditing work of the bank, while the cashier is the chief officer in direct charge of the banking operations including the supervision of the personnel and its organization. This personnel includes not only the employees engaged in the various phases of the banking business, but also the force of cleaners, carpenters, machinists, policemen, and chefs, if any.

Departments and Divisions.—In the work of managing the bank certain departments and divisions are created, as conditions warrant, to supplement the work of the officers. For example, a department known as the organization department is sometimes created to assist the cashier. Its chief function is to study the bank's departmental organization with a view to making improvements, and to watch the personnel for the purpose of discovering those who merit promotion. Furthermore, each major operation of the bank, such as receiving, paying, collecting, and extending credit, is organized as department with its own head and the

requisite number of assistant department heads. Related departments are grouped together into divisions, each of which is supervised by a division head. Through the organization department the division heads are responsible to the cashier for matters of operating procedure referred to them by department heads. In addition, they have charge of the personnel of their divisions. At regular intervals a meeting of the division heads may be held by the organization department for the purpose of considering improvements in organization and general operating methods.

The Problems of Bank Management.—Bank management covers an infinity of detail, but the main problems may be grouped for convenience of discussion as follows:

1. Obtaining new business.
2. The analysis of accounts to determine which accounts are desirable and which are undesirable.
3. The procurement of statistical information required for the efficient conduct of the business.
4. The management of the personnel of the bank.
5. Provision for the education and training of men for banking.
6. Procurement of legal information.
7. The study of methods by which the bank may serve its customers.
8. Checking up and handling in an economical manner the supplies used in the bank.

The more important of these phases of the management problem will be taken up in this chapter, it being understood that the description of methods refers to the practice of a large bank and is not applicable to all cases.

Securing New Business.—The most important and most insistent problem of management is that of enlarging and de-

veloping the bank's business. As pointed out before, the vice-presidents in each territory, or in a small bank some other officials, possibly the president and cashier, are constantly studying ways and means to develop new business. The progressive bank seeks not only to obtain new accounts but also to extend its business relations with those who are already its customers. Accordingly, every effort is made to bring new services of the bank to the attention of both old and prospective customers. New business comes to the bank in various ways. Where a bank possesses branches or agencies, these connections are important means of securing desirable customers. Many large banks keep a force of field men constantly traveling about to find new business. Again, new customers often apply for the use of a bank's more or less distinctive facilities, such as its foreign trade service or its foreign exchange information. If the applicant is of the type desired as a customer, an effort is made, when the service has been furnished, to extend relations with him. Thus new accounts are obtained either by personal solicitation or by means of publicity.

Bank Publicity and the Publicity Department.—Bank publicity may be either direct or indirect. Some banks rely mainly upon the general or indirect appeal of newspaper and magazine advertisements, or bill-board and theater program announcements. The material most frequently used in this form of advertising is the bank's financial statement. Such statements must be published according to law whenever a report of the condition of the bank is called for by the Comptroller, but banks frequently publish them of their own volition as a matter of publicity. A newspaper or magazine is often found to be a valuable medium to introduce some new service the bank is offering. For the most part, however, banks prefer to make use of direct publicity, in the form of special letters or announcements or advertising material sent directly to a carefully selected list of persons.

Where much effort is expended in direct-by-mail advertising, the work of preparing and keeping the mailing lists up to date, of editing the material, and publishing the periodicals and pamphlets is usually handled by a special publicity department. A considerable part of the material is often prepared by various officers of the bank, but the details and mechanics of work and the determination of the direction the publicity ought to take is usually delegated to trained publicity men.

Good examples of the modern form of bank publicity that is educational and informative, are the bulletins published by some of the larger banks, which discuss current economic and business conditions and analyze the social and governmental problems of the day. Such publications are of very general interest and their aim is to promote the influence of the bank among business men. They circulate widely, not only among clients and prospective customers, but among leading business and professional men in this country and in many foreign countries as well.

In addition to regular bulletins or periodicals of this sort, many banks issue special publications dealing with particular problems, such as analyses of foreign trade, income tax laws and rulings, a digest of the Federal Reserve Act and amendments, and similar topics. Furthermore, addresses of the bank's officers before important gatherings are frequently published for wide distribution.

Eliminating Undesirable Accounts.—Another problem in the management of a bank is to ascertain whether depositors' accounts are profitable or not. The actual work of making the calculations may be done by the bookkeepers, the auditors, or by other employees, the practice varying with each bank. The question itself is a managerial one. It is the aim of the bank officers to make as large a profit as is possible, consistent with sound banking methods. Therefore, it is important that the banker stop leaks and losses as well as that he increase income.

In the past it was usually assumed that any account which showed a credit balance was profitable. A little reflection shows that such an opinion is unsound, and undoubtedly many banks have lost a considerable part of the profit made on other transactions because they carried deposit accounts for individuals which, instead of yielding a profit to the bank, actually involved it in loss. Even accounts which show a large credit balance are not always profitable. The statement was made at a recent bankers' convention, that one banker refused to accept an account which would have shown an average balance of a million dollars. It was demonstrated that by so doing he saved money.

The Analysis of an Account.—In analyzing an account, the basis of the calculation is the average loanable balance. This consists of the average of the daily ledger balances of the account less the amounts not available to the bank for loaning purposes. The amounts not available consist of the reserve which must be maintained against the deposit and the uncollected funds contained in the balance. The reserve is the amount of cash or its equivalent which the bank must keep on hand to meet the demands of depositors. The uncollected funds consist of checks credited to the depositor's account but which have not yet been converted into cash by the bank. This net balance is computed for each period covered by the analysis. On the average loanable balance the gross income obtainable from the account is estimated. To get this a rate of interest is assumed on the loanable balance equal to the average rate obtained by the bank on all its investments for the period under consideration. This average rate of interest on the loanable balance gives the gross income for the period.

In order to obtain the net income three deductions must be made: (1) the interest paid to the depositor, if any; (2) the amount paid by the bank in the form of exchange for collecting certain transit items the cost of which was not assessed against the depositor; and (3) the cost of handling the account. It is a

very simple matter to ascertain the amount of interest, if any, actually paid on the account. The amounts paid for exchange are also easily ascertained.

Cost of Handling a Depositor's Account.—The expense of handling the account involves cost analysis. There are three expenses to be allowed for: first, the direct expense which is the expense incurred in handling the items arising in connection with the account. That is to say, each check the depositor draws and each deposit he makes, as well as the items he deposits drawn on other places, all require labor and the use of the bank plant and equipment which, of course, represent expense to the bank. The total expense for carrying on a given operation in a department—for example, collecting checks—for the period is estimated. The number of items handled in each department is then determined, and, by dividing the total cost of handling all the items by the number of items handled, the average unit cost for each item passing through the process is ascertained. This unit figure is multiplied by the number of items thus handled for the account under consideration, and, if this is carried out for all the operating services used by the depositor, the total of all such costs furnishes the bank with the direct expense of maintaining the account.

The second element in the expense is that incurred through special service rendered. It is frequently impossible to determine the actual expense per item. The cost of such service is therefore distributed on an estimated basis among the customers using this service. The kinds of service included here are suggested by the advice or information furnished on foreign trade or some similar matter. The third form of expense is the indirect or overhead expense. This includes the general and administrative expenses which cannot be directly allocated to the depositor's account. Because of the difficulty of distributing these fairly, they are sometimes ignored. At other times these expenses are distributed in an arbitrary manner. All of the expenses of mainte-

nance and the outlays for exchange and interest on the account are deducted from the gross income to arrive at the net income. This shows to what extent the bank profits from the account.

Some Accounts Indirectly Profitable.—While such analysis does not indicate profits with absolute accuracy, it nevertheless approximates them sufficiently closely so that the officials can determine whether a given account is worth keeping. Some accounts may be kept by the bank even though they do not show a profit, if the depositor has influential connections that bring the bank a large amount of other business.

Statistics an Aid to Management.—Certain other types of information are needed for the guidance of the officers of a bank. In a large bank the work of preparing and analyzing statistical data is of great importance, and some banks maintain special departments for the purpose of making researches regarding trade, production, transportation, finance, economics, and industry. This material not only is useful in formulating the broader policies of the bank, but it is closely connected with the publicity work. For example, the results of some of these researches may be published and distributed in pamphlet form for the benefit of depositors.

The Personnel Problem.—Another phase of the problem of managing a large bank is the personnel work. Its scope may be indicated by the following outline of the activities of a personnel department:

1. Engaging new employees.
2. Transferring employees.
3. Attending to resignations and discharges.
4. Answering inquiries about former employees.
5. Making job analyses.
6. Making studies of the salary question and preparing statistics regarding the working force.

7. Interviewing employees in order to ascertain their attitude toward other employees and the institution.
8. Conducting educational work among the employees.
9. Seeking in general to promote the well-being of the employees.

The engaging of new employees for a large bank is a problem of considerable magnitude and one which requires great care. Not only must candidates possess intelligence and ability of a high order, but they must also bear an unquestioned reputation for honesty and reliability. Applicants for positions in such an institution, whether they come on their own initiative, from an employment agency, through the introduction of an officer or a friend of the institution, or in reply to a general advertisement for help wanted, are required to file with the personnel department a standard form of application and to submit names for reference. The references are looked up by the personnel department and the information obtained is filed along with the application. When vacancies arise in large banks, the requirements of the position and the qualifications needed by the prospective employee are brought to the attention of the personnel department by means of requisitions signed by the department head and the division head, where this form of organization is followed. The personnel department then selects the most promising applicant for the place. When a new employee is engaged, he submits an application for a bond to insure the bank against losses for which he may be responsible. The bond must be approved as a rule, before he enters upon his duties, and practically all its cost is defrayed by the bank.

It frequently becomes necessary to transfer employees from one department to another. These transfers may be occasioned by changes in the volume of work in different departments, or they may be desirable because an employee in one department seems capable of doing more responsible work than that upon which he is engaged; or sometimes in the interest of harmony.

Where a personnel department is in existence, it usually has charge of such rearrangements.

When an employee has to be discharged, it falls upon the personnel department to advise him of the decision. The resignation of those who voluntarily leave the employ of a bank may likewise come to this department, and it thus has an opportunity of ascertaining the causes leading to these resignations. This information may later prove valuable as a basis for recommendations for the purpose of making employment in the bank more satisfactory. The hiring and training of new employees is expensive and troublesome, and one of the important problems of bank management is to reduce the labor turnover to its lowest terms. To this end the personnel department interviews employees in a sincere effort to locate any cause of dissatisfaction and to provide a remedy. Such interviews help to maintain a close personal relation between the institution and its employees.

The personnel department, in its effort to promote satisfactory relations with employees, prepares a periodical analysis of the salary schedules with recommendations for increases and promotions. Equal rates of remuneration for similar tasks are thus established and the danger of favoritism in promotions and salary increases is minimized.

Job Analysis—Welfare Work.—To assist the personnel department in selecting new employees, a detailed analysis of each position in the bank is made; the analyses are then used to determine the qualifications needed by the applicants. Records and statistics are kept so that at any time the personnel department can furnish information as to the location and work of any employee and an estimate of his value to the institution. Absences from work are checked up. If an employee is absent for a considerable length of time, effort is made to ascertain the cause and to assist him if he is in distress. Many banks carry on this sort of welfare work. In the small bank the officers and employees

are in such close touch that it is possible for those in authority to know the needs and difficulties of any employee, but in a large bank this personal touch is impossible. Nevertheless, attempts are made to promote the well-being of employees in many ways. Many large banks maintain a physician, and in some cases a small hospital, for the benefit of their staff and the medical men suggest the sort of exercise and methods of living that will increase the health and comfort of the employees.

Some banks have established social organizations in which employees may find recreation; others maintain club houses where their employees live in attractive surroundings and at a moderate price. Others again, provide some form of insurance, or pension scheme, whereby after a certain number of years' service an employee may retire on an allowance from the bank. Particularly during the war and reconstructing period, there was increasing use also of bonus systems and profit-sharing plans for employees. Finally, thrift is encouraged in a large number of banks by the establishment of a saving fund or investment fund in which employees may deposit their savings and on which the bank guarantees a very liberal rate of interest, sometimes running as high as 8 per cent.

Training Employees.—Closely related to welfare work is educational work, which has in view not only helpfulness to the employee, but the advancement of the bank. With the exacting requirement for employees in a modern bank, it is becoming increasingly difficult to obtain satisfactory persons who are properly trained. As banks expand and engage in a great variety of activities, more persons are needed for responsible positions. As competition for business becomes keener, the profit which a bank can make depends very largely upon its ability to see opportunities in advance of its rivals and to avoid the small mistakes which formerly were of slight moment. Hence the educational work of a large bank may be said to take two main directions: first, the

training of new men for employment; and second, providing opportunities for continuous education and training for the employees. Of course a great deal of this training is provided by other institutions.

One of the important agencies for the education of bank employees is the American Institute of Banking which has been organized under the supervision of the American Bankers' Association to provide social and educational opportunities for bank employees. There are in addition large numbers of universities and colleges and other training schools which furnish the preliminary training to a very considerable extent. Most banks find it desirable to supplement this training by what corresponds to continuation schools conducted by the bank itself or by private corporations specializing in this field. A few very large banks have established special training schools for the purpose of preparing college men for banking work.

Legal Problems in Bank Management.—A legal department or legal advisers usually are trained to aid the managers of a bank in handling problems which may have legal complications. To such department or advisers are delegated by the management the legal phases of claims and disputes which have not yet reached the litigation stage. Cases of forgery or check alteration, of examinations of the legal position of collateral, especially the legality of the issuance of bonds which are offered as collateral, the legal phases of all stop-payments on checks and bond coupons, requests for reimbursement on account of checks paid over stop-payment orders, requests for reimbursement because of lost checks, and similar cases, are handled by the legal advisers for the management. When a bank issues duplicates to reimburse its customers for lost cashier's checks and certified checks, the officers obtain through their legal staff the necessary guarantees, affidavits, and indemnity bonds. Injunctions and legal notices received by the bank are also referred to the legal advisers for

attention. The managers frequently call upon their legal staff to obtain payment for the bank of items which are past due or are unpaid for any reason.

The Fostering of Community Good-Will.—Another managerial problem is the development of ways in which the bank may render service to its customers and the community. Every banker in seeking to increase his business and his profits realizes that, in order to obtain the widest possible influence, his bank must make itself useful to those whom it wishes to attract as depositors. The average bank will go to great lengths to render a service for a depositor, and the variety of services is almost infinite. Some banks employ experts in various lines of business to make investigations and give information to depositors as to the manner in which they may increase their business. Furthermore, banks which have foreign connections make a specialty of giving the information which comes into their hands to such customers as may be interested in the development of foreign trade. Some banks maintain special financial libraries in which are collected all the important publications which may be of use to business or professional men in studying some particular phase of business or finance.

Buying the Bank's Supplies.—While the problem of buying, issuing, and economizing supplies is one of management, it is not peculiar to the banking business. The procedure followed generally by banks is the same as that which prevails in other large businesses. Supplies are purchased by one person or by one department which becomes thoroughly familiar with the qualities, prices, and markets for the various goods needed. Efforts are made to obtain the supplies under the most favorable terms; frequently dealers are requested to submit bids in competition with other supply houses. When the goods are received they are checked up carefully with the original order, and the bill rendered

is then marked correct so that it may be paid at the proper time. The supplies are permitted to go out to the employees only in exchange for proper requisitions. A current inventory is kept so that those having charge of supplies can make their plans and reorder at the proper time.

CHAPTER III

THE BANK AS A GOING CONCERN

Types of Banks—Commercial Banks.—Banking institutions may be divided, on the basis of the kind of business they do, into three classes: commercial banks, savings banks, and trust companies. While all three types are engaged in handling financial transactions, they differ in the kind of transactions dealt with and in the methods employed. A commercial bank deals mainly with persons engaged in commerce, and its business consists largely of receiving on deposit current funds subject to withdrawal on demand, and of extending loans to business enterprises desiring to use such funds for relatively short periods of time. Since the deposits of a commercial bank are subject to immediate withdrawal, the bank is necessarily restricted to the investment of such funds in short-term loans or highly liquid securities.

The chief functions of commercial banks are to finance, over space and time, payments arising in connection with industrial and trading operations. Persons who use such institutions do so either to obtain the convenience of transferring money from one place to another by means of checks, or to obtain an advance of funds to pay for materials or goods to be disposed of later at a profit. The possibility of spreading payments over intervals of time is made use of throughout the process of converting raw materials into finished products, and during the movement of such goods through the hands of the jobber, wholesaler, and retailer.

Savings Banks.—Savings banks are institutions organized for the purpose of providing a place of safe deposit and of investment for the small sums of money which are accumulated by

persons who do not expect to use them immediately but who are seeking to accumulate a fund of capital. A bank which devotes itself strictly to receiving savings accounts is not forced to repay its depositors on demand. Laws in different states vary, but most frequently such banks are permitted to demand a 30-or 60-day notice of withdrawal from depositors. Since their deposits thus are time deposits and are not expected to be withdrawn in the near future, they may be invested in long-time obligations such as real estate mortgages and corporation bonds. Usually the depositor is not permitted to draw checks against his savings account. Savings and commercial banks might be contrasted by saying that the former is a money bank while the latter is a check or negotiable instrument bank. The savings bank makes the great majority of its payments against depositors' accounts by means of cash over the counter, whereas the commercial bank makes most of its payments through the clearing house or through the mail by methods to be described later.

Trust Companies.—The third type of institution, the trust company, is organized primarily to act in a fiduciary capacity for individuals and corporations. Formerly it was the custom to have private individuals serve as executors and administrators of estates, as guardians for minors and incompetents, and as guarantors for persons in positions of responsibility and trust. This work is today largely in the hands of trust companies, which are better equipped for the purpose than private individuals because of larger financial resources, more expert judgment, and longer life.

Many Banks Perform All Functions.—While for purposes of analysis banking functions may be separated, in actual practice the tendency is for a single institution to assume them all. Thus we find national banks—originally designed as commercial banks—now operating savings departments and carrying on the

work normally performed by trust companies. Institutions which devote themselves exclusively to receiving and investing savings deposits are relatively insignificant in number. Corporations organized primarily to serve in a fiduciary capacity as trust companies, usually conduct both a savings and commercial business as well. The tendency to engage in all lines of financial activity has been referred to as the application of the department store method of banking.

The savings bank business is simple in character. Deposits consist in the majority of cases of actual cash; withdrawals are usually made only when the depositor presents his pass-book at the bank and receives cash in settlement; and the burden of investing the funds left on deposit is relatively simple because such banks are generally restricted in their choice of investments. In the present volume, accordingly, it is unnecessary to consider independently the operations connected with the receipt and care of savings deposits, as they are covered in a study of the operations of commercial banks, by far the most numerous class in this country.

The Field of Commercial Banking.—The evolution of the banking business is by no means completed. New functions are continually being introduced and the emphasis on old forms of business is continually changing. Through the granting or withholding of credit and through the insistence that their resources be advanced only for certain uses, banks tend more and more to direct the course of industry. The development and extension of foreign trade has come to depend largely upon the direction and assistance of bankers. The establishment of foreign branches and foreign agencies is constantly bringing the banker into closer touch with international affairs, and is thereby giving him power to influence political and economic changes throughout the world.

In directing the investments of private individuals, also, the banks are finding an increasing sphere of usefulness. The funds

available for investment in the hands of private individuals constantly increase, and to protect investors from their own folly effort has been made to get them to seek advice from their bankers before risking their funds in any enterprise. Hence the banks are not only called upon for advice but they are frequently asked to make purchases and sales of investment securities for their customers. Some banks in their desire to serve their customers sell to these clients some of the investments which they have made for themselves and then buy other securities with the funds thus released. Many banks give this service free of charge. In other cases the demand for a bank's advice and service has been so frequently made that separate companies have been formed by certain banks for the purpose of dealing in investment securities. These companies are usually owned by the stockholders of such banks. These changes in the nature of banking hold out greater opportunities in every phase of the business. They require, it may be said, for positions of responsibility men who have been much more thoroughly trained than the banker of the past generation.

Banks as Privately Owned Enterprises.—It is desirable, before examining in detail the various banking operations, to get a comprehensive view of a bank as a going concern, so as to see the manner in which many distinct operations contribute to the general purpose of the institution. No one of these operations, such as paying, receiving, and lending money, is carried on in an isolated manner as an end in itself, but is incidental to the main purpose of banking. What is this purpose? Or to put it in other words: What is a bank? A bank is a privately owned and usually incorporated business operated for the purpose of making profit by selling service of a financial character. Although banks are coming to be regarded more and more as public utilities, it must be recognized that they are established primarily for the profit of the stockholders. For this reason much of the popular criticism

directed against banks is improper. Banks in the agricultural regions, for example, have sometimes been criticized because they have preferred to make call loans in the New York money market rather than time loans to the farmers in their own community. Whether the charge be true or not, the criticism loses its force when it is recalled that the bank is a privately owned enterprise operated in accordance with the owners' ideas as to the methods which will insure maximum profits. If it is expected that rates of interest are going to advance or that the bank is likely to be in need of a supply of ready money some time in the near future, it would be wiser to invest the bank funds in a loan on which money could be obtained at a day's notice rather than in agricultural loans which would be likely to remain outstanding for a long time. On the other hand, the progressive banker seeks to adopt the line of action which will insure maximum profits in the long run, and hence the local loan, even though not so attractive at the time of negotiation as the loan in a distant market, may still be preferred if by granting it he secures the good-will and confidence of his customer. This good-will would be the foundation for continued prosperity. But the decision would rest on considerations of private profit and not primarily on any duty to the public.

A Bank's Services to Society.—The services which a bank sells in its effort to make a profit may be grouped under four main heads:

1. Providing facilities for the safe-keeping of money and valuables.
2. Providing machinery for exchange.
3. Making loans and manufacturing credit.
4. Serving in a fiduciary capacity.

It may occur to the reader that many activities are carried on in a modern commercial bank which do not seem to fall within any of these groups. Closer analysis, however, will demonstrate

that practically all bank operations contribute to the furnishing of one of these four main services, some directly and others incidentally as an outgrowth of the service rendered. In this volume the attempt has been made to group the chapters according to these functions.

Chapters IV and V have to do chiefly with the first service mentioned—that of providing a place for the safe-keeping of funds. Chapters VII to XV analyze the operations connected with the provision of exchange facilities. Chapters XVI to XIX discuss the function of providing credit. Chapters XXIII to XXV deal with the fiduciary and related activities. The incidental operations are treated in Chapter VI and in Chapters XX to XXII. Paying operations (Chapter VI) are necessarily incidental to receiving, lending, and providing facilities for exchange; and the various recording operations discussed in Chapters XX to XXII are necessarily developments in keeping the records of a bank's relations with its customers. Of these four main functions, the first three should be regarded as characteristic of the modern commercial bank; the fourth represents a new type of business development rendered necessary in many cases by competition between financial institutions.

Interrelation of Banking Functions.—It would be desirable, if it were possible, to discuss separately the activities which arise in connection with each banking function, but the functions themselves are so interrelated that it is impossible to complete the consideration of one without becoming involved to some extent in a discussion of transactions relating to other functions. Thus the receipt of deposits makes demands upon the exchange facilities of the bank; the deposit itself is in most cases the product of credit manufacture; and in turn the depositor receives the use of a convenient medium of exchange—the bank check or bank note. While there is much unavoidable overlapping in the discussion of these functions, this may be

ignored temporarily in an attempt to make clear their nature and importance.

The Deposit Function.—While probably not the first in order of development the provision of facilities for the safe-keeping of funds and other valuables is undoubtedly first in the consciousness of the ordinary observer today. That feature of the deposit business which consists in offering for rent safe deposit vaults for the keeping of valuable papers and similar possessions, is not an essential banking activity although most modern banks offer these facilities to their customers. However, it has been claimed that the deposit business as it has developed in modern times is the outgrowth of the safety deposit business of an earlier period. For example, it is asserted that the early money-changers and goldsmiths who provided themselves with strong-boxes and iron chests for the protection of their own valuables, also built up a considerable business in receiving for safe-keeping the coins, jewels, and other valuables of people who had no safe place in which to keep them, and that this practice has developed into the modern business of depositing funds for current needs.

Modern Character of Deposit Business.—It should be noted that the whole character of the deposit business in modern times has been changed. The original purpose of providing facilities for the safe-keeping of funds or valuables still exists where banks rent safe deposit boxes and where they receive deposits known as savings deposits. In selling to a customer the right to make use of its safe deposit facilities, the bank merely rents to him a compartment which it seeks to make as safe as possible; but it assumes no obligation with regard to these valuables other than that it will exercise all possible care in their protection. In receiving deposits of savings funds or of funds for current use, the bank becomes the debtor to the customer and makes itself responsible for returning to him an amount equivalent to his deposit.

The customer who makes a savings deposit, or, as it is sometimes called, a time deposit, does so with the intention of transferring the care of these funds to the bank and he looks upon his deposit as a form of investment since the bank obligates itself to pay interest on such sums.

Purpose of Modern Depositor.—In using the ordinary commercial account or deposit—which is the form of deposit chiefly discussed in this volume—the depositor seeks to make use, not so much of facilities for the safe deposit or the safe-keeping of his funds, but rather of the bank's facilities for the transfer or exchange of funds. He does not look upon the deposit as an investment and he does not usually intend to keep the particular funds deposited in the bank for more than a very short time. The customer of a modern commercial bank is not a depositor in the old sense, but is rather a purchaser of the bank's services in the provision of exchange facilities and in the extension of credit. This change is made clear by a consideration of the nature of the deposits made. To a very limited extent these deposits consist of gold, silver, and government paper money. To a somewhat greater extent they consist of national bank notes and federal reserve notes, both of which represent media of exchange created by banks. To a still greater extent they consist of checks, drafts, and similar items, which likewise represent media of exchange created by the banks; and to the greatest extent of all they consist of the proceeds of loans made by the bank by which a new kind of medium of exchange has been provided, namely, deposit currency.

Deposit Currency Created Through Loans.—If the student will compare the total of demand deposits for the banks of the country as a whole, with the total loans and discounts of such banks, he will note a striking similarity in amounts. If loans increase, deposits increase, and vice versa. These figures furnish

supplementary evidence that the bulk of the deposits in a commercial bank represent the proceeds from loans. The relation may be made clear by a numerical example.

Suppose that a bank begins business with a capital of $100,000 which has been paid in in cash. The situation would then be indicated on a balance sheet as follows:

Resources		Liabilities	
Cash	$100,000	Capital Stock	$100,000

Now suppose deposits of actual money are received to the extent of $100,000. The statement would then appear:

Resources		Liabilities	
Cash	$200,000	Capital Stock	$100,000
		Deposits	100,000

The bank is prepared to make loans to persons who can provide satisfactory security. Obviously the more money the bank can loan, the greater will be its income and profit. How much can it loan?

In the first place it has assumed the obligation of repaying its depositors $100,000 on demand. The managers of the bank, however, know that these depositors are not likely to withdraw their money immediately, for if they had intended to do so they would not have deposited the money. Furthermore, they can safely assume that while some money will be withdrawn from day to day, an amount approximately equal to or greater than that withdrawn will be deposited by old and new customers. Hence the managers know that it is unnecessary to keep on hand the whole of the $100,000 of cash deposited, and they know also that they may safely lend the $100,000 which the stockholders have invested in the enterprise.

Suppose they begin by loaning their own $100,000 to customers who choose to deposit the funds in the bank so that they

can transfer these balances by means of checks. The balance sheet would then stand as follows:

Resources		Liabilities	
Loans................	$100,000	Capital Stock.........	$100,000
Cash.................	200,000	Deposits.............	200,000

It will be noticed that the bank still has all the cash it had before and has merely changed its position in that it now has claims against other persons for $100,000 represented by loans, and that its customers have claims against it under the head of "Deposits" for an additional $100,000. Its cash is equal to its total deposits and therefore it could pay off all of its depositors with cash immediately if they should all make application at the same time. But as was said before, this is extremely improbable. Therefore, the bank managers know that they can increase their income further by loaning more money to customers who will request credit on the books of the bank rather than cash. Assuming that experience has shown that 20 per cent of the total deposits needs to be kept in actual cash, the bank could go on meeting the requests of customers for loans to the extent of $900,000. The balance sheet would then appear:

Resources		Liabilities	
Loans................	$900,000	Capital Stock.......	$ 100,000
Cash.................	200,000	Deposits............	1,000,000

Of course, this is an artificially simplified statement. Long before the business had reached the proportions indicated there would be many other items on both sides of the bank statement, but it serves to indicate the manner in which loans create deposits. The actual procedure of handling deposits of the character discussed here is taken up in the chapters dealing with receiving and lending operations.

The Exchange Function.—The second major function previously noted is that of providing facilities for exchange. In banking literature the word "exchange" has two uses. In one sense exchange indicates the process of trading or exchanging one kind of coin for another kind, and it is usually asserted that the earliest bankers were men who were engaged in this business. Merchants with coins received in various parts of the world were accustomed to resort to these money-changers for the purpose of exchanging the coins they had for others they desired. While this service is sometimes furnished by modern banks, it has long since become of very minor importance.

Exchange, as used in connection with the work of a modern commercial bank, indicates the transfer of funds from one person to another whether living in the same community or in places widely separated. This is, as Hartley Withers calls it, exchange of money here and now for money at some other point and some other time. If the identity of exchange operations with transfers of funds be kept in mind, it will be clear that the activities discussed in Chapters VII to XV are all connected with the same function—that of providing facilities for exchange. The methods and machinery of exchange are sufficiently discussed in those chapters, but it is desirable to consider the forms taken by the media of exchange which are furnished by the banks. These media may be divided into two main classes: bank notes and deposit currency. Bank notes may again be divided into two classes: those issued by the national banks, and those issued through member banks by the federal reserve bank.

National Bank Notes.—Banks which are chartered by the Comptroller of the Currency as national banks are permitted to issue notes by depositing with the Treasury Department of the United States an amount of United States government bonds of specified character equal to the amount of notes to be issued. These bonds are held by the Treasury Department as security

for the payment of the notes. So long as the bank lives up to the contract expressed when it issues the notes—that it will redeem each note at par in lawful money on demand—the bonds remain the property of the bank although they are kept as security by the Treasury Department. If, however, a bank fails or for any other reason refuses to pay cash for its notes upon demand, the government bonds deposited as security are sold and the money thus obtained is used to redeem the outstanding notes. At all times the issuing bank must maintain a redemption fund in gold amounting to 5 per cent of its outstanding notes at the Treasury Department, to redeem notes which may be presented for cash.

Advantages and Disadvantages of National Bank Notes as a Medium of Exchange.—The notes, uniform in appearance, and closely resembling the paper money issued by the government, are issued by the Comptroller of the Currency. They are maintained at par because of the fact that they will be redeemed by the banks themselves or by the Treasury Department and because they are secured by the deposit of an amount of government bonds equal to or greater than the notes outstanding. Thus, the advantages obtained from the use of national bank notes are: uniformity in appearance, unquestioned soundness, and greater convenience for use in making large payments than is the case with metallic money. They, however, lack in one important particular. As such notes are based on government bonds and therefore have no immediate connection with business, they do not expand or contract in accordance with the needs for currency. The country has on this account suffered alternately from the disadvantages of redundancy and scarcity in the medium of exchange. To increase the elasticity of the currency a new method of note issue has been established by the Federal Reserve Act.

Federal Reserve Notes.—Federal reserve notes are issued through the member banks on the security of commercial paper

or loans made to merchants, manufacturers, and traders. They can be issued only upon the application of a member bank which submits such commercial paper for rediscount. The maximum amount that may be issued is determined by the Federal Reserve Board. These notes, being connected directly with the demands of the business world, expand and contract according to needs. For example, if business is active and there is a great demand upon a local national bank for funds, such a bank can take to the federal reserve bank of its district some of the loans previously made by it and can obtain federal reserve notes equal to the value of the commercial paper. These notes are uniform in appearance and look like paper money. The borrowing bank thus has a new supply of notes which take the place of money and which may in their turn be loaned to local borrowers. The borrowing bank profits by the difference in the rate of interest which it charges the borrower and the rate which it must pay to the federal reserve bank for accommodation. Since both the local borrower and the bank pay interest on this amount while the notes are outstanding, the borrowing will not take place unless the activity of business makes it profitable to use such funds. Furthermore, if after the notes have been borrowed the debtor no longer needs them, he brings them back immediately for cancellation so as to stop the interest which is accumulating on them. Hence there is a more or less automatic adjustment between the supply of federal reserve notes and the demands of business.

Security of Federal Reserve Notes.—The safety of these notes is guaranteed first by the deposit of 100 per cent of their value in commercial paper which is indorsed and therefore is the obligation of a member bank; by the further deposit of 40 per cent in gold which the reserve bank must set aside for every issue of federal reserve notes; by the assets of the issuing bank upon which the note-holders have a prior lien; and finally, by the fact that the notes are obligations of the United States government. Their

redemption is provided for by requiring each reserve bank to redeem all notes issued by itself as well as those issued by any other reserve bank. A gold fund amounting to 5 per cent of the outstanding issue of notes is maintained at the Treasury Department to redeem such notes as may be presented there. The federal reserve notes have all the advantages possessed by national bank notes and have in addition the virtue of elasticity.

Federal Reserve Bank Notes.—The federal reserve banks may issue also federal reserve bank notes. These are notes based upon the deposit of government bonds, and in their issue and regulation resemble national bank notes. The purpose of permitting the federal reserve banks to issue these bank notes is to prevent a too rapid decrease in the paper currency of the country, which might occur if national banks should reduce their holdings of United States bonds and thereby contract the volume of national bank notes outstanding.

Deposit Currency.—The other type of medium of exchange is the deposit currency provided by any commercial bank. Deposit currency is the name given to the negotiable instruments, chiefly checks, which are used to make payments by transferring balances on the books of the bank from one individual to another. By far the greatest proportion of commercial transactions are settled by means of checks or deposit currency. The banks provide this currency just as readily as they provide bank notes or federal reserve notes. While note issues are limited to specified banks, as has been indicated, all commercial banks which receive deposits and allow checks to be drawn upon them are providing deposit currency. The deposit upon which checks are drawn may consist of actual money, or its equivalent, brought in by the customer and credited to his account, or it may be created in a sense by the granting of a loan by the bank, the proceeds of which loan furnish the ledger balance upon which the checks are drawn

Relative Advantages of Deposit Currency and Bank Notes.—It is usually a matter of indifference to the banker whether he provides bank notes or deposit currency as a medium of exchange, for he collects the same rate of interest on the credit which he extends in either form, and his obligation to pay lawful money on demand is the same in either case. As compared with bank notes, deposit currency has certain advantages and certain disadvantages from the standpoint of the public. The two forms of currency are equally satisfactory, in that they provide a convenient method of transporting large sums of money. Checks have an advantage over bank notes, however, because they can be drawn for any amount, whereas bank notes are issued in fixed denominations. Another advantage of the check is that in case of loss payment may be stopped by the maker and a new check may be issued to transfer the funds, whereas in case of a loss of bank notes, since the notes are payable to bearer without any necessity for indorsement or identification, the one who has lost them is usually unable to obtain recompense. On the other hand, while deposit currency is more elastic than national bank notes and adjusts itself to the needs of the commercial world as readily as federal reserve notes, it is at a disadvantage as compared with bank notes and federal reserve notes because checks drawn on a given bank do not readily circulate over as wide an area as do bank notes. The reasons for this are twofold: first, checks do not look as much like government paper money as do either national bank notes or federal reserve notes, and hence they are not accepted as readily by many persons who are not in touch with banking institutions. Secondly, bank notes have back of them the guarantee both of the issuing bank and of the government that they will be redeemed on presentation, whereas a check drawn upon the bank balance of an individual is good or not according to the financial standing of the maker. Since the maker of a check is ordinarily not known over a very wide area, his checks are likely to be accepted only within the restricted

region within which he is known, and only by the people who know him.

The Loaning Function.—The third main function which it is noted the bank performs in its operation is that of making loans. This function is of great importance to an industrial society. In making loans the bank acts both as an intermediary between borrowers and lenders, and as a manufacturer of the credit which it extends to the borrower. In the first relationship the banker serves as a specialist in credit. He obtains from a large number of persons deposits of sums for which they have no immediate need, and in turn he loans these in various amounts to borrowers. Very few individuals having small sums of money which might be available for lending purposes, have any knowledge of the persons who are desirous of using such funds; nor have they any knowledge of the credit standing of most of these borrowers. The banker therefore performs a very real service by collecting the scattered sums available for lending and putting them in the hands of those persons who are entitled by reason of their ability and standing to use them.

The great bulk of the loans, however, grow out of the creation of deposit balances for the benefit of borrowers, as described earlier in this chapter. Through these loaning operations, banks finance the transformation of raw materials into finished goods and enable merchants and traders to carry them until they ultimately find their way into the hands of consumers. If one considers the extent to which persons at various stages in the production of a given commodity, from the raw to the finished state, make use of credit to get possession of materials and to postpone paying for them until the goods have actually been passed to the next person in the line of production and the money has been received for them, he will realize what an important part the lending operations of a bank play in the carrying on of the world's business. The importance of the bank in the economic scheme might be

figuratively indicated by saying that the bank in the exercise of the loaning function acts as a sort of moving belt or platform carrying the burden of production from one stage to another in the industrial process.

The Fiduciary Function.—The fourth main bank service—that of acting in a fiduciary capacity—represents the assumption of duties which have gradually come to commercial banks. Since banks are entrusted with the funds and valuable papers of the community, and since on account of the nature of their business they have become familiar with various types of investment and with financial procedure, it is natural that the public should more and more look to them for advice. It is also natural that they should be entrusted with carrying out the wishes of persons who plan to make financial provisions after their death for individuals or institutions. Furthermore, in financial transactions between large business enterprises on the one hand and thousands of individuals on the other hand, it is necessary that some trustworthy and responsible third party be available who will see that both groups in the transaction are given proper consideration, and it is most natural that banks should be chosen for this purpose. The various types of fiduciary and representative services of financial institutions are discussed in subsequent chapters.

The Accounting Operations of a Bank.—In carrying on the operations which center in these four main lines of service which the bank sells, certain records must of necessity be kept. The essential purpose of the records or accounting of a bank is to furnish information concerning the relations that exist at any time between the bank and its customers. Since the bank is debtor to many individuals and creditor to many others, it is necessary that ledger accounts be kept to indicate the status of each individual and his relationship with the bank at a given time. Another type of information required by the bank managers is

that which is in the nature of an inventory. The bank has many things of value belonging to itself and to others. These consist of cash, stocks, bonds, real estate, warehouse receipts, and various other forms of property. Records showing the property on hand and indicating the ownership must likewise be kept. Furthermore, the bank is engaged in business—it seeks to make a profit. It is therefore in receipt of an income and is constantly incurring expenses for operation. For the benefit of its shareholders information is needed as to the progress which the bank has made from one period to another. Records such as balance sheets must therefore be prepared to furnish information as to the status of the institution at various times.

Besides these records which are required for the purpose of obtaining information concerning the bank's business, there are certain other accounting operations which are carried on for the purpose of verifying and checking over the work that has already been done. For example, a complete set of duplicate ledgers may be kept merely to check up the information which has been recorded in a similar series of ledgers. A large part of the bookkeeping or recording which is performed in a bank is of this nature. The necessity for accuracy in a bank's records is so great that very elaborate systems of duplication and proof are adopted. Obviously the complexity of a bank's accounting system varies with the character and volume of its business, but all banks must record in some form the three types of information which have been indicated. The status of the bank and the results of all of its operations are finally summarized in the bank statement, which shows in total the bank's relations to its shareholders, depositors, and other creditors on the one hand, and its valuable property and claims against debtors on the other hand.

Similarity in the Work of Large and Small Banks.—In discussing in detail the operations of a modern commercial bank, it must be remembered that while the work of a large metropolitan

bank is more varied and more complicated than that of a small town bank, there is in essence close similarity between them. The apparent differences in organization and procedure grow chiefly out of the minute division of labor necessitated by the larger volume of business transacted by the metropolitan bank. A great many of the records and processes of a large bank which are unfamiliar to those accustomed to small bank operations, are merely methods of dividing and checking up the work which is performed by one man and covered in one process in the smaller bank. There is also complete unity in these operations. Just as in a fighting army there are thousands of persons behind the firing line who are not actually engaged in the fighting but who are nevertheless absolutely essential to that fighting, so in the large bank there are many employees who seem to have no connection with the furnishing of these four types of service which the banks sell. These employees, nevertheless, are all carrying on operations which are performed for the sole purpose of aiding either in receiving deposits, providing facilities for exchange, lending money, or acting in a fiduciary capacity.

CHAPTER IV

OVER-THE-COUNTER RECEIPTS

The Receiving Function—Origin of Deposits.—The receiving operations in their broadest sense include all activities connected with the bank's acceptance of sums of money or its equivalent—that is, checks or other items which may be converted into money —for credit to the accounts of its customers.

There are three channels through which deposits to be credited to customers' accounts come into the receiving teller's department. They may be presented "over the counter"—that is, by personal delivery by the customer or his representative at the receiving teller's window. They may be sent in by mail, telegraph, or express, in which event they sometimes go through hands other than those of the receiving teller, as for example, the mail department employees. Or finally, they may originate in various other departments of the bank, such as the collection department or the loan department. Whatever their origin, all receipts to be credited to the accounts of the bank's customers represent receiving operations although the transactions may be handled, for the sake of convenience, by employees other than the receiving tellers.

Cash Items and Collection Items.—The materials handled in the receiving operations may be divided into two main classes: cash and cash items, and collection items. In a small bank both classes are accepted and receipted for by the same person, but in large institutions the receiving teller accepts only cash items. Included in this term are currency, checks (except under certain conditions), sight drafts, certified checks, and coupons from United States bonds. Sometimes other items may, by special arrangement, be received on a cash basis.

The chief distinction between cash items and collection items is that the former are received for immediate credit against which the depositor may draw his own checks, whereas the latter are received subject to collection, the bank acting merely as an agent for the depositor. The depositor's account is not credited and of course he cannot draw against the item until the funds have actually come into the possession of the bank. The method and machinery for handling collection items are described elsewhere in this book; in this discussion of the receiving operations attention will be confined to cash and cash items.

Relation between Deposits and Loans—The Cash Reserve.— The relation between the receiving operations and the other operations of a bank are very close. One of the most important relations is that between deposits and loans. The usual statement is that loans increase deposits, since in most cases the borrower does not desire money in exchange for his promissory note —taking instead credit on the books of the bank. Hence an increase in the loans of the bank is nearly always reflected in an increase of deposits. But deposits cannot be increased indefinitely merely by an increase in loans. Every time the deposit balance of a customer is increased, the strain on the bank's cash reserve is increased, since the customer has a legal right to present his check and demand the full amount of his balance in cash at any time. It would be perhaps more precise to say that loans increase deposit liability rather than that they increase deposits. The amount of deposit liability that the bank can build up by means of loans is limited by its stock of cash either in its vaults or subject to its call. Both law and sound banking practice require the maintenance of a sufficient stock of cash to meet any ordinary demands which may be made by depositors. This stock is called the cash reserve. One of the main sources from which the cash reserve is supplied and replenished is the receiving teller's department.

The above statement applies, of course, to the individual bank, and not to the banking system as a whole. When cash or checks on other banks are deposited in a given bank, its cash reserve is increased at the expense of other banks save in so far as the money deposited has come from hoards or represents a reduction in the amount of currency in circulation. Except under these two conditions, the only way to increase the cash reserves of the banking system as a whole is to reduce loans or to obtain a larger share of the world's stock of gold by selling securities and commodities abroad.

Relation to Other Phases of Bank Activity.—The receiving operations are also related to the other activities of the bank—the paying teller is engaged mainly in paying cash according to the orders of the depositors in his bank; the transfer of money from one person to another and from one place to another (exchange activities) is effected by increasing and decreasing deposit balances in the banks involved in the transfer; the collecting activities have for their purpose usually the obtaining of cash to be credited to a customer's account; and the bookkeeping or recording operations obtain a large part of the material with which they work from the receiving teller.

The Function of the Teller.—The word "teller" which originally signified one who counts or reckons, has come to be used in a wider sense in banking circles. While it still is true that one of the functions of a modern bank teller is to count money, he by no means devotes all his time to this sort of work, nor is he the only one of the bank employees who performs such tasks. However, it is accurate enough to say that, so far as the steady customer of the bank is concerned, the chief activity of the two people with whom he always associates the title of teller—that is, the receiving and the paying tellers—is to count and check up the money as it goes either into or out of the bank.

Receiving and Paying—The "Unit" System.—In the small bank or bank of moderate size, there is frequently no distinction between those who receive and those who pay money. The same persons at one time receive and at another time pay money. But in a large bank the work both of receiving and paying is so heavy that experience has shown the desirability of allowing certain men to specialize in one function and other men to specialize in the other.

In some large banks the division of labor has been carried out in a slightly different manner. Instead of restricting the teller to one function only, the division is made in the ranks of the customers and each teller performs both functions but deals only with a limited number of people. These customers are grouped alphabetically, and all persons whose names are included in a certain alphabetical range transact all their business with one teller, who both receives and pays money for members of the particular group. This is known as the "unit system." In the great majority of large banks, however, the division is made on the basis of separation of function between receiving and paying.

The Receiving Teller's Work.—The usual duties of a receiving teller may be said to include four processes: (1) receiving and verifying the deposits; (2) giving proper receipt for the same; (3) distributing the various items deposited; and (4) checking up and proving the day's work.

The volume of work handled by the receiving, or second teller's department varies not only with the size of the bank but more particularly with the nature of the business done. Thus a bank with a large number of local tradesmen and manufacturers as depositors will have a much larger number of transactions for its receiving teller to handle than will a bank whose depositors are mainly out-of-town banks who are using the metropolitan institution as a correspondent. In the latter case the bulk of the deposits come to the bank by mail or express.

The Deposit Slip.—Before making his deposit, the customer, who is in most cases familiar with the regulations of the bank as to the conditions under which it will accept items as cash, indorses his negotiable instruments (checks and drafts), counts his money, and prepares a deposit slip. One of the most important duties of the teller is to verify the deposit slip so that no error will be made in giving the customer credit for the amount of his deposit.

Receiving Teller's Responsibility.—The usual sources of error connected with receiving deposits are: errors in counting the money deposited; the presence of counterfeit or badly mutilated money; errors in the addition of deposit slips; carelessness or error in designating the account to be credited—for example, a deposit slip representing a credit for the account of John J. Smith might be headed merely "John Smith" or "J. J. Smith," whereas the bank might have other accounts under similar names. If the deposit were credited to the wrong account, much trouble might later ensue for the bank.

Again, there may be defects in the negotiable instruments deposited. The more common defects concern the signature, the indorsement, the date, and the quality. As to signature, if the item is one signed apparently by one of the bank's depositors, it must be determined that it is valid, i. e., not a forgery; or, in case of a corporate account, that it is signed by the person authorized to sign. The items should be indorsed first by the person to whom they are made payable, and second by the bank's customer if he is not the original payee. This indorsement gives the bank a sufficient record of the item, so that if any difficulty concerning its payment later arises, the bank can, by referring to the indorsements, determine immediately from whom it received the item and to whom it should look for reimbursement.

Postdated Checks, Stale Checks, Duplicates.—In the matter of date, care must be exercised to see that the check or other item

is payable at the time presented; that it is not postdated—dated some days later than the day of presentation. On the other hand, "stale" checks—checks which, to judge from the date, have been outstanding for a long time since originally issued—must be watched for. In such cases it is usually desirable to ascertain, before crediting the item to the depositor's account, whether it is still valid, inasmuch as many things may have occurred since its issue to make its payment doubtful. The maker may have stopped payment on the item; he may have issued a duplicate which has already been paid; his bank balance may have been attached; or he may have withdrawn all or most of his funds on the assumption that all his checks have long since been paid.

Stop-Payments—Attached Accounts.—Finally, the quality of the item must be established. Checks, or other cash items, may not be good, because either the maker has no account, or, if he has an account, does not have sufficient funds to pay the checks when presented to the bank upon which they are drawn. Again, an item may be of no value because payment has been stopped. A stop-payment order is an order given by a depositor to his bank directing it to refuse payment of a certain item, the number, amount, date, and payee of which he designates in the order.

The causes for the order may be various; the maker may have changed his mind and decided not to pay the amount; there may have been some dissatisfaction with the goods or services in exchange for which the check was given; or the item may have been lost or stolen and he may have issued a duplicate check which he desires to have paid instead of the original. The maker of a check may stop payment of his items at any time before his bank has actually paid them, and the bank is required to carry out his orders. Accordingly the bank keeps a record of all stop-payment orders and its employees are constantly on the alert to see that no items are paid which its customers have ordered not to be paid.

If the items deposited are payable at other institutions in which the receiving teller does not know that payment has been stopped, they are received only subject to payment by the bank upon which they are drawn.

Still another cause rendering the payment of an item impossible is the attachment of the maker's account. For various reasons the court may direct a bank to hold the balance in a certain customer's account subject to its orders, in which event, of course, the depositor himself has no control over the account and any drafts made upon it by him must be dishonored by the bank.

Alterations of Checks.—Finally, care must be taken to see that the cash items deposited have not been altered in any respect. The chief dangers in this connection are that the original amount of the item may be raised or that the date may be altered so as to make payable immediately an item which the maker intended to have paid at some future date.

It is obvious that it is physically impossible for one man to exercise close supervision over all the material passing through his hands if the number of items is large. To facilitate the handling of deposits in a large city bank, the burden of making these examinations is shifted to others in the receiving teller's department and to those who record and transmit the material after it has passed through the receiving teller's hands. Thus the proving force of the receiving department verifies the accuracy of the deposit slips. The bookkeepers are responsible for detecting all checks which cannot be paid because of stop-payment orders, insufficient funds, forgeries, alterations, and missing indorsements. The money department examines all money received. Under such a system the receiving teller looks only for those defects at the window which cannot readily be discovered afterwards, and he receives the deposit subject to correction if any defect should later be discovered.

The Depositor's Receipt—Credit Advice.—Having accepted and verified the deposit, the receiving teller gives the depositor a receipt, usually in the form of an entry in a pass-book or a duplicate deposit slip. This receipt is evidence of a credit to the depositor's account, subject to correction. The depositor ordinarily then is entitled to draw checks against this credit and expects to have them honored on presentation at the bank. The bank has by the process increased its holdings of cash or cash items to the amount of the deposit.

While a receipt is usually given for deposits, as just described, banks receive some deposits which require different treatment. For example, a city bank may receive from an out-of-town correspondent a shipment of currency for credit to the correspondent's account. For such a shipment acknowledgment is made by means of a letter advising the receipt and credit. Often, too, deposits are made by one party, with the request that a special advice of such deposits be sent to another party. The most numerous deposits in this class are those of branch offices and agents of various large enterprises, such as a railroad company, the main office of which desires to keep an independent record of the receipts of branches and agents.

Certificates of Deposit.—Among the most important receipts which are issued by many banks are the certificates of deposit, or deposit receipts, as they are sometimes called. A certificate of deposit is a receipt given for a deposit which has been accepted by a bank under special agreement. The conditions under which withdrawal may be made, the rate of interest to be paid on the deposit, and the length of time during which the funds are to remain in the possession of the bank, are all specified in the agreement. Such funds are not subject to check and usually may be withdrawn only as a whole. Transfer of ownership of the deposit can generally be made only on the books of the bank. The variations in the form of these certificates are numerous but they may

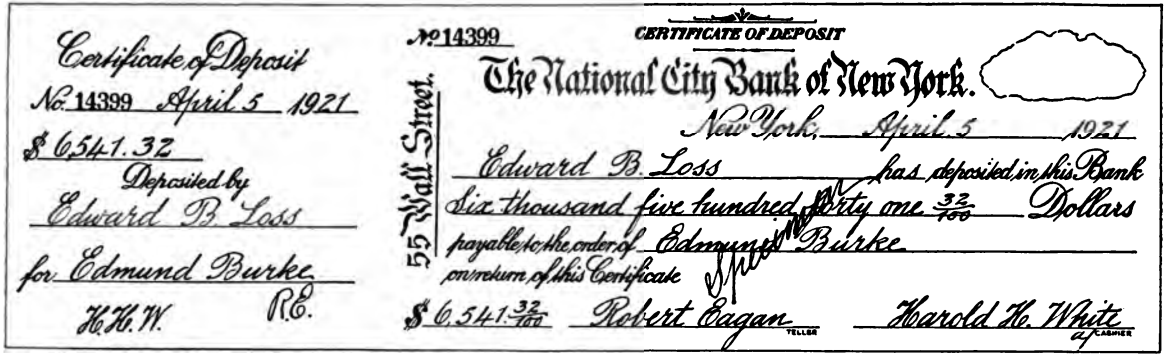
be classified accurately enough under three main heads: demand certificates, definite time certificates, and indefinite time certificates.

Demand Certificates; Time Certificates.—A demand certificate of deposit (Form 1) is a negotiable instrument made payable at the option of the beneficiary upon return of the certificate. No interest is allowed. The most common use of such a certificate is to transfer funds in a manner similar to the bank draft.

A definite time certificate of deposit is payable upon the return of the certificate properly indorsed after the expiration of a certain period of time, always 31 days or more. This minimum period is established in order to meet the classification of the federal reserve law, which designates deposits subject to withdrawal after 31 days or more as time deposits. Against time deposits members of the federal reserve system are required to carry only 3 per cent reserve, whereas against other deposits they must keep from 7 to 13 per cent, depending upon the location of the bank. These time certificates are not negotiable, the funds being transferable only on the books of the bank. They bear interest at a rate agreed upon between the banker and depositor, and are used largely for the temporary investment of idle funds.

Indefinite time certificates (Form 2) are payable after a certain number of days' notice by the payee, but only after a certain minimum period of time has elapsed. While such certificates are payable at the option of the holder after the earliest date for payment has arrived, the bank virtually fixes a maximum time during which the item is to remain outstanding by inserting a provision that interest upon the amount represented by the certificate shall cease after a certain date.

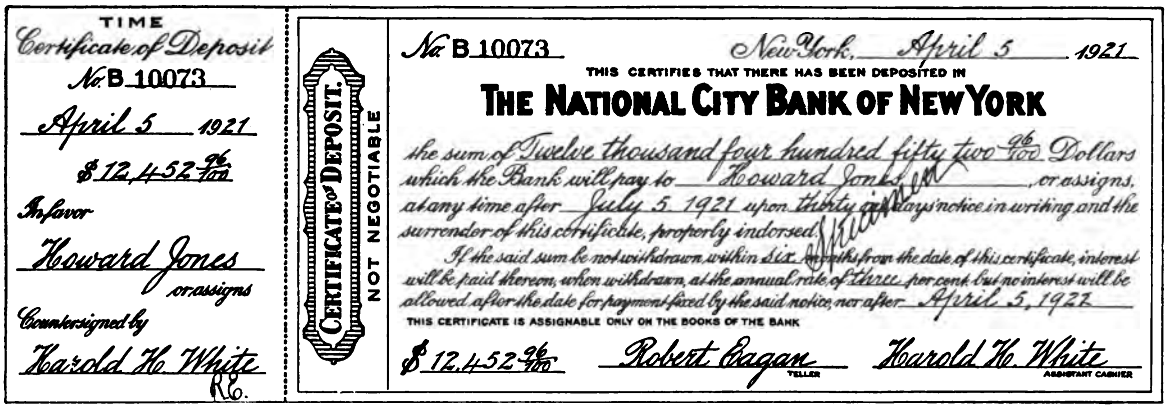
Records and Distribution of Deposits.—Certificates of deposit are issued upon the application of the customer and with the approval of an officer of the bank. In a very large bank where a


Certificate of Deposit
No. 14399 April 5 1921
$ 6541.32
Deposited by
Edward B. Loss
for Edmund Burke
H.H.W. R.E.

55 Wall Street.

No. 14399
CERTIFICATE OF DEPOSIT
The National City Bank of New York.
New York, April 5 1921
Edward B. Loss has deposited in this Bank
Six thousand five hundred forty one 32/100 Dollars
payable to the order of Edmund Burke
on return of this Certificate
Specimen
$ 6,541 32/100 Robert Eagan TELLER Harold H. White A. CASHIER

Form 1. Demand Certificate of Deposit. (Size 11¾ x 3½.)


TIME
Certificate of Deposit
No. B 10073
April 5 1921
$ 12,452 96/100
In favor
Howard Jones
or assigns
Countersigned by
Harold H. White
R.E.

CERTIFICATE of DEPOSIT.
NOT NEGOTIABLE

No. B 10073 New York, April 5 1921
THIS CERTIFIES THAT THERE HAS BEEN DEPOSITED IN
THE NATIONAL CITY BANK OF NEW YORK
the sum of Twelve thousand four hundred fifty two 96/100 Dollars
which the Bank will pay to Howard Jones, or assigns,
at any time after July 5 1921 upon thirty days' notice in writing and the
surrender of this certificate, properly indorsed.
If the said sum be not withdrawn within six months from the date of this certificate, interest
will be paid thereon, when withdrawn, at the annual rate of three per cent but no interest will be
allowed after the date for payment fixed by the said notice, nor after April 5, 1922
THIS CERTIFICATE IS ASSIGNABLE ONLY ON THE BOOKS OF THE BANK
Specimen
$ 12,452 96/100 Robert Eagan TELLER Harold H. White ASSISTANT CASHIER

Form 2. Indefinite Time Certificate of Deposit. (Size 11¾ x 3½.)

special group of auditors is maintained by the bank, two stubs may be prepared with each certificate, one being retained by the official signing the certificate and turned over by him to the auditors. This stub enables the auditors to check up the certificates so as to make sure that none has been issued without authority. The other stub remains in the certificate book as a record of the transaction. The certificate is purchased either by the payment of cash or by check on the customer's account. In the first case cash is debited; in the second the customer's account is charged. The Certificates of Deposit account is credited for the amount of the certificate.

The third phase of the receiving teller's work is the distribution of the various materials which have been deposited. He begins and ends the day with a clear desk. The greater part of the work of distribution is performed in the afternoon, an exception being made in the case of very large items. Such items are sent through immediately in order that the bank may collect the funds the same day and thus avoid the loss of a day's interest which would result if the items were not put through until the afternoon.

The majority of the deposits which come to the receiving teller's window are made in the afternoon, for most customers desire to wait until the bulk of the day's receipts are in before making their deposits. During the morning the bookkeepers are occupied with certain routine duties and, in a large bank, are posting the items which have come in by mail and have been sorted out and distributed by the mail teller's department. To aid the receiving teller during the afternoon rush, some of the clerks from other departments which have their heaviest work in the morning are transferred to assist in the work of sorting, proving, and distributing the day's receipts.

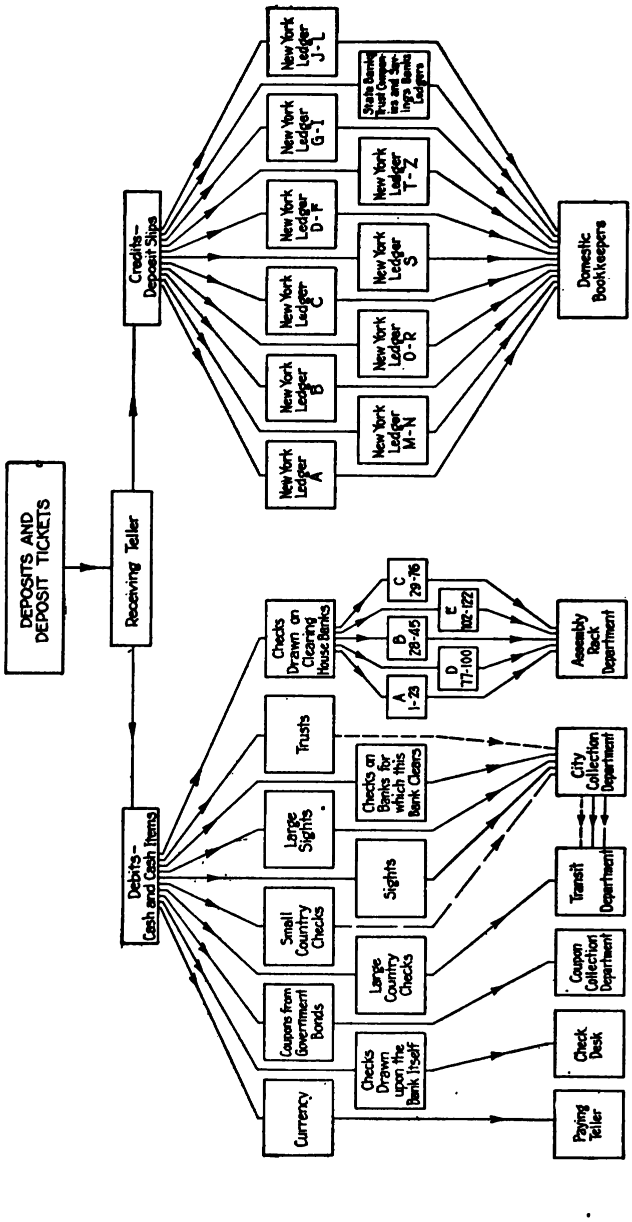
Nature of Materials to be Disposed of.—Bank receipts comprise two main groups: the deposit slips; and the items making up the deposit. The deposit slips indicate the amounts to be credited

to the customers' accounts, while the items received for deposit are debited to cash. "Cash" includes not only money, which is the meaning ordinarily ascribed to the word, but it includes also checks and other items which can be converted into money.

From time to time, beginning early in the afternoon, the deposit slips are sent to the bookkeepers as rapidly as a sufficient number accumulate. The slips are first sorted into groups according to the subdivisions of the depositors ledgers, and those contained in each group are sent to the bookkeepers in charge of that ledger. For example, if one bookkeeper has charge of the accounts of customers whose names begin with any letter from A to E, he receives the deposit slips for any deposits made by such persons. A triplicate record of the totals of these slips is sometimes made by the receiving teller's department. One of the copies is forwarded to the statement clerks who post the credits to the statements of account which are issued at intervals to the bank's customers; the second copy accompanies the deposits which it represents through the proving process; the third copy furnishes information for a report to the general ledger bookkeepers, showing the total credits sent by the receiving teller to each of the depositors ledgers. The same items are thus posted by the individual ledger bookkeeper, the statement clerk, and the general ledger bookkeeper. This makes it possible for the work of each department or division to serve as a check upon the work of the others.

Sorting the Deposit Items.—The items which are listed on the deposit slips by the customers must be distributed to the proper departments for attention. Hence they are sorted in batches according to their nature and the procedure for handling them. The following is a characteristic sorting (see also Form 3):

1. Clearing house items—those which are payable by banks that clear through the local clearing house.
2. Checks drawn upon the bank itself.



Form 3. Chart Showing Disposition of Items Passing Through Receiving Teller's Department

Sights, trusts, and small country checks are held overnight. Hence they appear on the city collection department proof since this department maintains the hold-over account. The checks themselves, however, are sent direct to the transit department where they are prepared for collection the following day.

3. Sights—sight drafts drawn upon persons in the city who must be reached by messenger in order to obtain payments.
4. Trusts—drafts upon persons in the city who can be reached through the city collection department of the clearing house.
5. Small country items—checks of less than $500 drawn on out-of-town banks (in the afternoon these checks are separated from large country items because they are to be put aside for the night force of the transit department in order that the undivided attention of the afternoon force may be given to sending out the larger items).
6. Large country items—out-of-town checks which are large enough to make it worth while to despatch them for collection on the day of receipt.
7. Cash—usually the actual money is taken out of the deposit and cash tickets are substituted therefor.
8. Checks drawn upon banks for which the bank clears.
9. Large sight drafts—city items large enough in size to make it profitable for the bank to collect them by messenger on day of receipt.

The Batch or Block Proof.—After sorting the items in each group in some such manner as suggested above, a list is made of the contents and is attached to each group. The totals for all the lists are added, and this total, if no error has been made, will correspond exactly with the total of all the deposit slips of the particular batch which has been distributed to the bookkeepers. This proof is called a "batch" or "block" proof (Form 4). The block or batch proof offers certain obvious advantages over a single daily proof. It distributes throughout the day the work of "proving" and thus lightens the work which has to be done at the close of the day. It enables the teller to detect the existence of error within a comparatively short time after receiving the de-

Sorted by Robert Eddy

Listed by John Kelly

Clearing House	Division A 1-23		140	431	14
	Division B 28-45		35	140	67
	Division C 59-76		38	283	49
	Division D 77-100		21	769	56
	Division E 102-120		371	521	16
	No. 8		39	692	01
	Sights			77	01
	Trust Co's		8	568	94
	Small Countries		5	183	50
	Large "		76	260	88
	Cash		1	365	05
	8 Sights		6	098	59
	F X 8			872	30
	Large Sight Drafts		219	000	00
	Total		964	264	30
New York A. 6			457	048	66
New York B. 6			293	405	00
New York C 4			29	406	07
New York D F 8			184	404	57
Total			964	264	30

Form 4. Receiving Teller's Batch Proof. (Size 5½ x 8½.)

"8 Sights" means drafts drawn on banks for which this bank clears. "F X 8" means items drawn on the foreign division of the bank.

posit; if the mistake is one which requires that the depositor be communicated with, it is to the advantage of the bank and the depositor that this be done as soon as possible after the deposit has been made. Finally, the batch proof reduces the number of transactions that must be rechecked in order to locate an error, and this method of proving isolates an error so that it holds up only a relatively small amount of the work.

After the correctness of the work has thus been demonstrated, these various groups of debit items are distributed to the proper departments of the bank for final record and disposal. According to the foregoing grouping the disposition would be made as follows; items in group 1 would be charged to the paying teller as the equivalent of cash, but would be sent directly to the assembly rack to be prepared for clearing; those in group 2 would be charged to the check desk and be sent there to be prepared for the bookkeepers; those in groups 3, 4, 5, and 8 would be charged to the city collection department, but the small sight drafts, trusts, and small country items would be sent to the transit department to be sorted by the night force if the volume of business is large enough to warrant a force of employees for the day and the night; those in group 6 are charged and sent to the transit department; in group 7 the cash is charged and sent to the paying teller.

The Receiving Teller's Daily Proof.—The daily proof of the receiving teller (Form 5) is obtained by consolidating the various batch proofs in order to show: (1) the credits to all other departments of the bank for the aggregate amounts received from such departments; (2) the debits to all other departments for items passed to them during the day; (3) the charges which have been made to the accounts of the bank. A departmental proof is therefore a condensed journal record of the entire work of such department for a given day. At the end of the day's business the receiving teller has cleared his desk. The total of all the deposits

which he has received is balanced by the sum of the cash and cash items which he has passed on to the departments that are to record and collect them.

SECOND TELLER'S PROOF, Dec. 31, 1921.

Transit Dept.,	2,975,530	51	Deposits,	48,112,487	46
Check Clerk No. 8,	12,186,400	23			
Paid to 1st Teller	36,763	97	Rec'd from 1st Teller,		
" 3rd "			" 3rd "		63
" 4th "	942,170	44	" 4th "		
" 5th "			" 5th "		
Large Sight Drafts,	539,658	86			
Small Countries,	890,047	09			
Sight Drafts	660,721	23			
Trust Co's,	1,423,366	14			
Clearing House Exchanges,	28,457,829	62			
Total,	48,112,488	09	Total,	48,112 488	09

Form 5. Receiving Teller's Daily Proof. (Size 8¼ x 8¼.)

Collection Items in the Receiving Process.—Although the collecting activities of a bank represent a distinct function and are so treated in this book they are in a sense to be regarded as part of the receiving operations. For the most part collection items left with the bank represent deferred deposits inasmuch as the depositor expects to have the proceeds credited to his account as

soon as they are available. When the bank is advised that certain collection items have been paid, the advice is usually accompanied by a draft or other cash item in settlement of the proceeds. This debit is sorted and handled in the usual manner while the letter of advice is made the basis for a credit to the customer's account.

CHAPTER V

OTHER RECEIPTS

The Mail Teller and His Work.—Credits for customers' accounts come to the bank over the counter, by mail and express, and as the result of transactions in other departments. The previous chapter dealt with the first class of receipts; this chapter will consider the other sources of deposits and the methods of handling them.

In a small bank the receiving and acknowledging of deposits sent in by mail present no special problem. When the mail has been examined, the letters which contain deposits are referred to the receiving teller. He or his assistants verify the contents with the letter of the depositor, make up a deposit slip if one has not been enclosed, acknowledge receipt of the remittance, and file the original letter for any future reference that may be necessary. In a large bank, particularly an institution which is the depositary for hundreds of out-of-town banks, and which also has a large number of foreign customers, the handling of the mail becomes a tremendous task and requires a department which devotes itself exclusively to taking this part of the receiving work off the hands of the receiving teller. The head of such a department is usually known as the mail teller, or the fourth teller, and the functions of the department are to receive, prove, record, distribute, charge, and acknowledge the cash items which come to the bank by mail. Of course a large number of letters are received each day which do not contain cash items for deposit, many of them pertaining to a great variety of other transactions not at all related to the receiving operations. These letters are sorted out and distributed to the proper departments or persons.

In banks where the volume of mail is large, a division is made

so that the night mail, the morning mail, and the afternoon mail are each handled as a unit. The night mail consists of letters received since the closing hour of the preceding day and of "hold-overs," or items retained from the previous day's work. The terms "morning mail" and "afternoon mail" are self-explanatory. The work of sorting and distributing the materials which come by mail goes on almost continuously, a night force and a day force being engaged in the work.

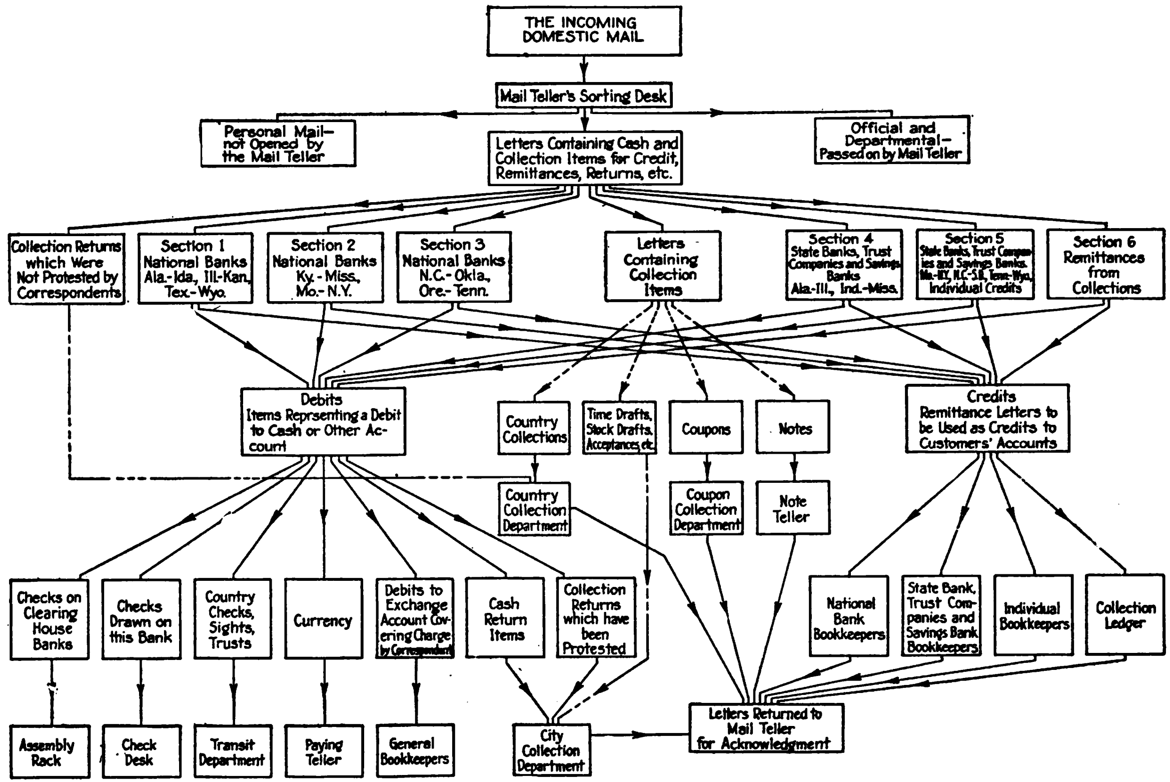
Preparing for the Clearing House.—Handling the morning mail is the main event in the day's work of a large mail teller's department. Literally, thousands of letters, containing thousands more of enclosed items, come into the department for attention at this time. Moreover if the bank wishes to send the clearing house items contained in the letters through the clearing house on the day of receipt, only two hours are available for completing the whole mass of work. It is also necessary that the other operating departments of the bank receive their work from the morning mail in time to complete it before the items of the receiving teller begin to arrive in large numbers. To meet this situation the mail department expands to several times its normal size, drawing additional workers from various departments in which the early morning work is light.

Opening the Mail.—The mail comes first to a force of openers, who carefully examine each letter for cash enclosures. This force lays aside for other departments those letters which do not contain cash items, as they bear no further relation to the work of the mail teller. Each examiner places a numbered stamp, which has been assigned to him for the day, upon the back of each letter. Responsibility for error in examining the letters is thus fixed upon the one who made the examination. After opening the letters, the clerks clamp each cash letter with its enclosures and pass it to the sorting force.

Sorting the Mail—The "Rack."—The letters are divided into sections corresponding to the grouping of the names of the customers on the bank's ledgers. To handle the work contained in each of these sections, what is sometimes called a "rack" force is in operation. The term "rack" indicates a box of pigeonholes into which items are sorted, but it has also come to be used to designate the work of sorting items into the rack. For example, the "afternoon rack" and the "assembly rack" are spoken of. Each rack force operates as a unit. The work of the rack consists in proving the letters, sorting the enclosures for distribution throughout the bank, and preparing a proof of the work of the section as it is completed (see Form 6). The letters which come into the bank may contain only cash items or only collection items or both. The collection items are deducted from the footing of the cash letter if they are included therein because, as explained before, the bank does not allow credit for them until they have been paid. These items are sent to the collection department with such instructions pertaining to them as are included in the customer's letter.

Proving the Cash Items.—After the collection items nave been eliminated, the cash items are proved. The batch is divided into two parts: the letters representing the credits to customers' accounts, and the enclosures representing the debits to cash. This division corresponds to the method used by the receiving teller in preparing his batch or block proof; the total of the deposits, it will be remembered, was compared and proved with the total of the items (debits to cash) which appeared on the various deposit slips. In making the rack proof, the total of the credits called for by the letters is compared with the total of all the items making up these credits, and if the totals agree the batch is regarded as proved.

The Mail Teller's Daily Proof.—The daily proof made by the mail teller (Form 7) in a large bank is one of the most elaborate



Form 6. Chart Showing Disposition of Cash and Collection Mail Items Received by Mail Teller's Department

Broken lines represent bills covering exchange charges deducted by correspondents, and sent through the collection ledger rather than credited to the customer's deposit account when such bills represent collections sent out on a remittance basis.

proofs used in the bank. When the batches are proved and distributed, the proof sheets are retained as a record of the work. To make up the proof for the day's work the totals of the various

FOURTH TELLER'S PROOF *Dec. 31-1921*

A. M. Transit Dept.	2,762,430	62	Credit Journal,	41,467,314	56
Check Clerk No. 8,	9,316,892	69			
Clearing House 1st Teller,	20,675,033	57	Rec'd from 1st Teller,		
Paid to 1st Teller,		37			
" 2nd "			" 2nd "		
" 3rd "					
" 5th "			" 3rd "	804,382	03
Sight Drafts,	4,874,439	32			
Cash Items,	2,202	75	" 5th "	794,679	07
			" Foreign Dept.	1,400,230	48
Total,	37,630,999	32	Total,	44,466,606	14
P. M. Transit Dept.	645,473	68			
Check Clerk No. 8,	1,664,769	73	Rec'd from 1st Teller,		
Clearing House Exchanges,	3,538,580	67			
Paid to 1st Teller,			" 2nd "		
" 2nd "					
" 3rd "			" 3rd "		
" 5th "					
Large Sights,	419,450	06	" 5th "		
Small "	459,285	69			
Countries to Transit Dept.	107,574	05			
Cash Items,	472	94			
Total,	44,466,606	14	Total,	44,466,606	14

Form 7. Fourth or Mail Teller's Daily Proof. (Size 9 x 9¼.)

sheets in each section (the term "section" here referring to all the accounts carried in a particular ledger, such as all accounts from A to E) are assembled by the mail teller. If each batch has been made up correctly, it is clear that the total of all of them taken together must balance. That is to say, at the end of the day the total of all the cash mail received must be equal to the total of all

the items which the mail clerks have taken out of such letters. These proof sheets are filed away in order to provide a permanent record of the work of the department.

Accounting for Exchange Charges.—The cash items which were found enclosed in the letters are then sorted and distributed to the other departments of the bank for record and filing, or for conversion into cash or its equivalent. Besides the ordinary cash items, there are some which demand special explanation. First are those which involve payment of exchange charges. An exchange charge is a charge levied by the drawee bank or by some intervening bank, acting as collecting agent, for its service in collecting the item; the amount of the charge is deducted from the face of the item, and must be paid either by the bank which originally received the item or by its customer. A more complete discussion of the reasons for, and the determination of, exchange charges occurs in Chapter VIII. When advice is received that an item which has previously been charged in full to the account of a correspondent bank has been subject to a deduction for the exchange charged, the letter which advises the amount of the charge serves as the basis for a credit to the account of the correspondent bank.

Returns—Protests.—Another group which requires explanation is that of the return items. These are checks, drafts, and notes which, although previously sent as cash items and charged to the accounts of correspondents, are now returned with a request that the charge be removed because the banks charged have been unable to get the money for the items. The reason for the inability to collect may be insufficiency of funds in the account of the signer, or a stop-payment order, or it may be forgery or other irregularity with respect to the document itself. Sometimes these items are protested before being returned.

A protest is merely a notice in legal form which establishes the

fact that the check or other item in question has been duly presented at the proper place for payment and that payment has been refused. Except under special conditions, protest is necessary to hold the indorsers liable for the payment of the item, if the maker does not pay it. Usually, though not necessarily, a protest is effected through a notary public, and, of course, certain charges and expenses are incurred. When this is the case, these charges are added to the original amount of the item and the total is sent back with a request that the bank upon which the item was drawn, and which was previously charged, be now credited for such amount. The first bank now gives credit and reimburses itself by securing the amount of the item plus the protest fees, if any, from the customer who, as shown by the indorsement, originally deposited it.

Recording Interest Delays.—Besides the operations strictly to be defined as receiving, there are various incidental activities connected with the receipt of deposits by mail. One of the most important of these is the examination of the items sent in for deposit with respect to the time likely to elapse before the bank can obtain the actual money called for by the deposit. If the deposit is made up of checks drawn on banks in various parts of the country, the collection of some of them may entail delay of a day or two—some perhaps a delay of six or eight days—before the receiving bank actually obtains the funds.

If a bank is paying interest on the credit balance of a customer, it is obviously unfair to expect it to compute interest on such balance if made up of items for which the bank will be unable to obtain cash for several days. Hence, although such items are credited immediately to the depositor's account, care must be taken to see that interest is not computed on that portion of the balance which will remain for some days uncollected. In order to make sure that these items are not included in the balances upon which interest is computed until sufficient time has elapsed

for their collection, some of the employees engaged in handling the mail indicate the "interest delays" on each item. When the letter then reaches the bookkeeper as a credit to the customer's account, the bookkeeper makes note of the time when the various items will commence to draw interest.

Instructions Accompanying Deposits.—Another of the duties associated with the receipt of deposits by mail is the carrying out of instructions which have been given by the depositors. Some of these are "standing," or permanent instructions, such as the request to advise a home office of deposits received from its branches, or to wire advice of payment or non-payment of items of a certain size. But in addition to these standing orders, banks frequently receive letters which embody special instructions. Of course, every bank which is seeking to give satisfactory service tries to carry out the instructions of depositors as fully as possible, and hence when the volume of the mail is large it may require a considerable amount of time and labor to carry out the special instructions received.

Foreign Deposits by Mail.—In the receipt of deposits from foreign customers certain differences appear. The most striking of these differences is probably the practice of making certain that items deposited will be paid before the amount is even credited to the customer's account. Usually only United States money and checks payable in New York City are accepted. Each check must be drawn to the order of the receiving bank or must bear a well-known indorsement. If a check of considerable size is drawn upon a neighboring bank, it is sent to such bank for certification before being credited to the account of the depositor. Finally, checks drawn on the receiving bank are assured of payment by the fact that the bookkeepers are instructed to "hold" a sufficient part of the drawer's balance to pay such checks when they are regularly presented later in the day. Receipt for foreign deposits is

6

made usually by sending a special advice of credit, rather than by the issue of a duplicate deposit slip or by an entry in a passbook as is done in the case of domestic deposits.

Characteristics of a Bank's Mail.—The receipt, distribution, and acknowledgment of the general mail are, as was said before, mere incidents in the work of a small bank; and even in handling the mail of large banks few problems present themselves which are peculiar to the banking business. The bank does the same work in general in dealing with the mail that any other large industry does. There arises, however, one important difference as compared with other businesses: the volume of registered mail coming in and going out of banks is considerably larger than that of other businesses of similar size. This unusual volume is explained by the fact that valuable papers, investment securities, and even money go in and out of the banks through the mails. As to outgoing mail, care must be exercised in a bank, as in any other business which handles a large volume of mail, to see that the expenditures for postage and registration are properly accounted for, to see that the letters are properly addressed, that they contain the proper enclosures, and give the information which the correspondent has requested.

Translators, Investigators, Routers.—In those banks which do a considerable amount of international business a few other interesting facts about the mail are encountered. Obviously, mail from foreign countries, written in different languages, may often require translation by experts.[1] Obviously, also, in handling a large volume of foreign business, it is natural to expect that misunderstandings and differences will often arise because of the varying methods of doing business in different countries. In order to smooth out these differences and remedy the complaints,

[1] The manner in which this work is handled in a large bank with international affiliations is described in Chapter xxv of Langston's "Practical Bank Operation."

a staff of special investigators is maintained. Finally, there are the special problems of routing. The despatching of mail to foreign points requires the services of a special staff because the sailing schedules of the various mail steamers must be kept in mind, and because documents covering goods shipped to foreign ports are usually sent in duplicate or triplicate and each copy is sent by a different carrier. In order that the consignee shall not be delayed in obtaining the goods because of the tardy arrival of documents which he must have before he can claim the shipment, it is necessary that great care be taken in routing the mail, to send it as speedily as possible. Sometimes, indeed, it is possible to send the letters and documents covering a shipment of merchandise by the vessel which carries the goods. Mail sent in this way is spoken of as consignee mail. A knowledge of the vessels upon which goods destined for export are being shipped is required to handle such transactions.

Receipts Through Note Teller's Department.—Those deposits have been mentioned which come over the counter through the receiving department, and by domestic and foreign mail through the regular mail department. Other departments also serve as channels for the receipt of deposits which are of a more or less heterogeneous nature. In a large bank practically all these miscellaneous deposits are made through the note or third teller's department. Some deposits, for example, come to the bank by express; these are disposed of by the note teller's department, which handles the items in the same manner as the mail teller's department handles items received through the mail. In certain special cases the note teller's department receives mail remittances also. If, for example, items are mailed to the bank for deposit but without sufficient instructions as to how to dispose of them, they are turned over to the note teller, who carries the funds in a suspense or holding account, such as the Cashier's account, until the wishes of the sender are ascertained.

Except for the credits that are made to customer's accounts to correct erroneous charges, practically the only other sources of deposits are the loan and discount departments. When, for example, a customer secures a loan, he receives in exchange for his promissory note a credit to his account.

Reflection of Receiving Activities in Bank's Statement.—The problem of chief interest in connection with the credits to customers' accounts from loans made by the bank is the manner in which the credit is arranged for. This matter will be discussed fully in Chapter XVI. It is sufficient to note here, in connection with the function of receiving, that the deposit liabilities of the bank, and thereby the credits of customers, are increased as well by loans as by deposits in any other manner. When a loan has been negotiated, the loan and discount department, the note teller, the receiving teller, or some other employee—the procedure varying with the size of the bank and its plan of organization—prepares a credit slip for the customer's account and charges the account of Loans and Discounts in the general ledger. This transaction is reflected on the bank's statement in an increase of assets as represented by the addition to loans, and an increase in liabilities as represented by the addition to deposits.

CHAPTER VI

PAYING

The Paying Function Defined.—The second important banking operation is that of paying or cashing checks and similar claims upon the bank. The paying function covers all the activities connected with the maintenance of an adequate supply of cash to meet the demands of customers and with the payment of money in response to those demands. Although the function is simple, the work is often heavy and exacting. The receiving operations, as has been stated, result in giving to a large number of customers the right to demand payment in cash of the full amount of their balances at any time. The bank is a debtor to these customers and their claims must be met upon demand.

The Teller's Responsibility.—The position of the paying teller is one of great responsibility. In the first place, he is the responsible custodian of the whole supply of cash which the bank has on hand at any given time. Whereas the receiving teller begins and ends his day with a clear desk, the paying teller begins the day with a large supply of cash on hand and at its close is responsible for the currency taken in by the receiving teller and other employees during the day. In the second place, while the receiving teller deals almost exclusively with depositors of the bank, the paying teller may be called upon to make payments to, and transact business with, many persons who are not depositors. These points of difference between the work of the two tellers are important because, if the receiving teller should make an error there always remains the possibility of correcting it without any loss to the bank by charging or crediting the difference to the customer's account; if for any reason checks deposited are

returned unpaid, the receiving teller may feel confident that he will have no difficulty in recovering the money, because the deposit has been made by a customer of the bank. The paying teller, on the other hand, often pays out money to persons whom he never sees again. Money paid to such individuals in error is not likely to be recovered unless the recipient voluntarily brings it back.

Furthermore, even when the person receiving the money is a customer, the risk of loss is greater in paying cash than in receiving it. There is a finality about the paying teller's transactions. The receiving teller may look back over the checks and other items deposited, and if an error is detected may then make the necessary corrections on the customer's deposit slip. While the paying teller may refer to the checks or other items he has handled during the day, he has little check upon the amounts he has paid out. He has no means of detecting, for example, whether he paid William Brown $110 in error for the check of $100 which his records show Brown had cashed during the day. For this reason he must exercise the utmost watchfulness over every transaction.

The Department Personnel.—The paying teller's department, sometimes referred to as the first teller's department, consists of the teller and the assistants required by the size of the bank and the volume of business handled. The volume of work varies at different periods of the day. In general it is heaviest, in the ordinary commercial bank, in the morning. During the morning many business men call for supplies of currency of various denominations to take care of their needs for the day; the bank clearings come in the morning and settlement must be made by the teller for the amounts owed by his bank to other members of the local clearing house association, and the checks to be charged to the accounts of the bank's depositors must be distributed to the bookkeepers, as early as possible in the day.

The responsibility for the safe-keeping of the bank's cash

rests upon the paying teller alone. Great care is taken to make sure that no persons except those working immediately under his direction shall have access to the cash. Therefore, the tellers with their cash and records are usually enclosed in "cages" or compartments surrounded by steel or brass grill work or sometimes by plate glass. Only the teller and his authorized assistants are permitted to enter the cage during business hours.

The Work of the Paying Teller.—The day's work of the paying teller and his department may be considered under five main heads:

1. Counting and verifying the cash receipts of the bank.
2. Keeping and safeguarding the supply of cash.
3. Paying cash.
4. Distributing the items exchanged for cash to the proper departments of the bank.
5. Proving the day's work.

Besides these main activities, certain incidental duties devolve upon the tellers, some of which may be of considerable importance in large banks but occupy only a small amount of the teller's time in smaller banks. Examples of these duties are making up the bank's pay-roll, paying out and keeping a record of bank expenditures and the petty cash account, and certifying checks for depositors. In banks where such work becomes onerous, separate departments are sometimes organized, as for example, a certified check department.

The Sources of the Bank's Supply of Cash.—The supply of cash which the bank carries comes from various sources. In the case of a national bank, part of this supply consists of the notes issued by the bank, as described elsewhere in this volume (page 47). A second source is the federal reserve bank. The manner in which money is thus obtained has likewise been explained elsewhere (page 48). A third source of supply is found in other

banks, as when one bank borrows temporarily to meet its needs from other banks with which it has business relations. A fourth source is the nearest sub-treasury,[1] from which the bank obtains currency for an equivalent amount of cash in some other form. In general the receipts from the sub-treasury do not result in augmenting the supply of cash, although occasionally the bank may receive a net addition to its cash from the sub-treasury when the United States Treasurer transfers government deposits from the sub-treasury to the banks. The fifth source of supply consists of deposits and payments of currency which are made to the various departments of the bank in the course of the day's business, and this is by far the most important supply with which the paying teller has to deal.

Counting and Sorting the Money.—The receiving teller, as well as every other employee who receives cash for the account of the bank, transfers all such receipts from time to time during the day to the paying teller, taking his receipt therefor. The paying teller then becomes responsible for all moneys received, however large in volume or varied in form. This currency must be sorted according to denominations, must be carefully examined to see that it is genuine and not mutilated, must be verified as to amount, must be put up in convenient packages for handling, and must be safely stored. The supplies of currency which come to the bank from other banks, from the sub-treasury, the federal reserve bank, and from the Comptroller's department, are accepted without question and usually require no further examination because they are already put up in convenient packages and there is no doubt either of the accuracy of count or of the genuineness of the pieces.

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[1] In connection with this and subsequent references to the sub-treasuries, it should be remembered that Congress provided for their abolition in the Legislative, Executive, and Judicial Supply Bill, approved by the President on May 29, 1920. According to the law the sub-treasuries must be discontinued by July 1, 1921, and their functions be taken over by the twelve federal reserve banks.

Guarding Against Counterfeit Money.—Where the amount of currency handled is very large, the work of counting and packing the money is given to special employees in the paying teller's department under the charge of the teller. The money is counted and verified by two or more persons, the work being done by hand except in the case of minor coins. For these, machines which sort, count, and wrap into packages the different kinds of coin are in general use. The final responsibility for detecting uncurrent money rests upon the money teller and his assistants. As they verify and put up the currency into packages for storing, they count it and inspect it for its genuineness. While doing this work they are constantly on the lookout for counterfeit money. The work of counterfeiters is frequently done with such skill that it does not arouse the suspicion of the ordinary observer. But the experienced teller develops his senses of touch and sight to such an extent that he can in the great majority of cases detect counterfeit money as it is passing rapidly through his hands. Perhaps something slightly unusual about the appearance of the currency attracts his attention; perhaps there is a greasy "feel" to the coins which he recognizes as unusual; or a slight variation in the weight may attract his attention. To supplement his knowledge each teller has a copy of the "Counterfeit Detector"—a periodical which gives a description of each known counterfeit reported by banks, secret service agents, and others interested in detecting counterfeit money. When a piece of counterfeit money is discovered the bank mutilates it by stamping it "counterfeit" and turns it over to the secret service agents, charging the amount back to the customer from whom it was received.

Raised and Mutilated Money.—Other matters the money tellers have to look out for are raised and mutilated money. Raised money is encountered much more frequently than counterfeit currency but its detection is relatively simple. The money counters sort the money by kinds and denominations. Since a

raised note bears the engraving of a lower issue than the one it purports to be, it is readily detected in the bundle of notes of higher denomination.

All mutilated and badly worn bills and coins are laid aside to be exchanged for new currency—usually without expense or trouble—at the nearest sub-treasury or federal reserve bank. Mutilated gold and silver coins and under-weight gold coins can be redeemed only at their bullion value. In such case the bank disposes of them and gives the customer who deposited them credit only for the amount realized from the sale. Light silver coins and mutilated paper currency are redeemed by the government at their face value in most cases. If, however, a piece of paper money is so mutilated that less than three-fifths but more than two-fifths remains, such a bill is redeemed by the government at half its face value. If less than two-fifths remains it is worthless, except that any fragment of paper money will be redeemed at its face value, provided the holder furnishes an affidavit stating that the remaining portion has been wholly destroyed and describing the means by which it was destroyed. The sub-treasury redeems coins and legal tender notes, while the local federal reserve bank redeems federal reserve notes. National bank notes are redeemed by the Treasurer of the United States.

Preparing the Money for Storage.—After the money has been counted and verified it is prepared for storing. To facilitate this work, money is sorted as to kinds and denominations and is put up in standard size packages. Paper money is sorted into gold certificates, silver certificates, legal tender notes, federal reserve notes, and national bank notes. While each bank may have its own units or standard packages, there is a good deal of uniformity throughout the banking world in the plan of wrapping money. The following is the usual method: hundred-dollar bills in packages of $2,500; fifty-dollar bills in packages of $1,000; twenty-

dollar bills in packages of $1,000; ten-dollar bills in packages of $500; five-dollar bills in packages of $250; two-dollar bills in packages of $50; and one-dollar bills in packages of $50. The minor coins are wrapped in rolls as follows: fifty-cent pieces in rolls of $10; twenty-five cent pieces in rolls of $10; ten-cent pieces in rolls of $5; five-cent pieces in rolls of $2; one-cent pieces in rolls of fifty cents.

The Vaults and Protective Devices.—After the money has been put up in convenient packages and safely stored, another duty of the paying teller is to see that an amount sufficient to satisfy the requirements of the bank is constantly at hand. The safe-keeping of the money is provided for by large vaults and safes made as nearly impregnable as possible. The doors of both vaults and safes are usually equipped with combination and time locks so adjusted that they cannot be opened until the lapse of a certain number of hours. Thus, when the teller at the close of the day's business sets the time lock so that it will release the mechanism after eight o'clock the next morning, it is impossible to obtain entrance to the safe or vault legitimately before that time. In addition the banks in large cities are usually equipped with electric signal devices which give notice to a central office if any attempt is made to tamper with the doors after they have been locked. Some vaults and safes are so equipped that if they are opened improperly the intruder will be scalded by jets of live steam. As a further measure of protection persons who are known to the police of large cities as criminals are prevented from even entering the financial district.

The Cash Inventory; Relation of Cash to Loans.—To make sure of an adequate supply of cash for the bank's needs, the paying teller maintains a running inventory or rough proof showing the kinds and denominations of money in stock. Every time this amount is altered by additions or withdrawals, he alters his figures

to correspond, so that at any given moment during the day he can by reference to his proof sheet tell exactly how much cash the bank has on hand.

Reserve; Paying Teller's Cash; Assistant Teller's Cash.—In a large bank the supply of cash is divided into three portions, each of which is kept separate from the others. These are the reserve cash, the paying teller's cash, and the assistant teller's cash. The reserve consists of the surplus cash kept as a sort of safety fund to meet unusual demands. The paying teller's cash consists of what may be called the bank's working cash—that is, the amount required to meet ordinary demands; and the third portion consists of the cash to be used by the assistant paying tellers in their work of cashing checks.

Paying Cash Against Checks.—The third main activity of the paying teller's department is that of paying cash to those who present checks or other orders to the bank. These checks and orders may be divided into two main classes, those which are drawn on the bank itself, and those which are drawn on other institutions. The first class is by far the larger. To consider the less important first, the items drawn on other institutions and presented to the paying teller's department to be cashed consist of checks, drafts, certificates of deposit, post-office money orders, express money orders, coupons, and similar instruments.

The essence of these transactions is that the paying teller gives out some of the supply of cash for which he is responsible, to a customer of the bank in exchange for the implied obligation of another bank or institution to pay his bank a similar amount. It must be clear that the teller would not make such payment unless he felt sure that the institution or person who is ultimately responsible for such payment will recompense his bank in full for the amount thus advanced. Since, in most cases he knows little or nothing about the standing of the drawer of such check or

other item, he relies upon his knowledge of the customer and the customer's willingness and ability to return the money in case the order to pay is not complied with when presented to the bank upon which it is drawn. This means that the teller must know the person for whom he cashes an item drawn on another institution. Usually, therefore, the teller will cash items drawn on other institutions only when presented or indorsed by depositors.

Orders on the Paying Bank.—The cashing of checks drawn upon his own bank involves somewhat less risk of loss, inasmuch as the teller can ascertain before paying any money whether the drawer has sufficient funds on hand to meet such payment and whether a stop-payment order or similar obstacle makes payment impossible. On the other hand, the teller has certain added responsibilities. If an item is payable elsewhere, he need have no concern as to whether the drawer has sufficient funds or whether payment has been stopped because, if he is satisfied as to the responsibility of the person who obtains the money, he can always feel confident of recovering in case the item is dishonored. When, however, he cashes checks on his own bank he is expected to ascertain, before paying the money, whether the item is good or not; and he is furthermore responsible not only for the protection of the bank but also for the protection of the depositor.

Protection of the Depositor and Bank.—The depositor may properly expect that his checks will be paid promptly if he has sufficient funds, and that no checks will be charged to his account which have not been properly drawn and signed by him. As the representative of the bank, the paying teller must be sure that the check is valid in every respect. As the representative of the depositor, he must be on guard against the forgery of the depositor's name, and be sure that the check is not one on which payment has been stopped. He must see that the payee acknowledges the receipt of the money or its equivalent and thus

discharges the signer of the check from further liability for its amount as shown by the indorsement. The payee must indorse the check if he presents it in person. If the payee is not known to the teller, he must furnish evidence of his identity so that the teller may know he is the proper person to receive the money. If the check is given to another person the validity of such transfer must be indicated by the payee's indorsement. Usually the teller requires the one who presents the item to indorse it also, in order that he may have a record showing to whom the money has been paid. Finally the teller must see that the date of payment is correct. If he fails to safeguard the depositor's interests in any of these respects, not only does the bank lose the customer's good-will and his business, but the possibility exists of the injured depositor's bringing a suit for damages against the bank.

Signature Records and Stop-Payment Lists.—While the work of paying checks is one of great responsibility, the task is lightened by the fact that records are kept to which the teller may refer at any time when in doubt about the validity of a check. He becomes familiar by experience with the signatures of the majority of the depositors, and he can usually tell at a glance if it is genuine. If he has any doubt about it he refers to the signature card upon which the depositor when opening an account signs his name. The signature cards are filed in alphabetical order, usually in the paying teller's cage; if more than one copy is kept, the additional files are deposited in other departments.

The teller must know whether the check of the drawee is good or not. Familiarity with the bank's accounts enables him to pay with confidence the items drawn by the majority of the depositors. If he has any doubt about an account he refers to the bookkeeper and ascertains whether the depositor has sufficient funds to meet the check in question.

In handling stop-payment orders the teller also has at hand a list or series of cards showing the items upon which payment has

been stopped within the past week or two. In addition to this record the bookkeeper frequently marks on his ledger a notation of all stop-payment orders that have been entered by the depositors whose accounts he handles. He is expected to observe and call attention to any checks whose payment has been stopped, if the teller has paid them and sent them out to be entered upon the ledger.

Finally, to safeguard the interests of the depositor, the paying teller must be alert to detect any irregularities in items presented for payment. For example, he must be sure that the amount and the date on the check have not been altered by someone other than the maker. If there is any appearance of irregularity it is his duty to refuse payment until he has communicated with the maker.

Other Duties of the Paying Teller.—In addition to his responsibility for the payment of items at the window, the paying teller of a large bank is in charge of certain other payments. A large city bank may be requested by national banks located in other places to make payment to the Treasury for the account of the 5 per cent redemption fund which all national banks are required to maintain against their outstanding note circulation. Frequently customers request the bank to make shipments of currency to themselves or to others for their accounts, or they may require gold to be sent to foreign countries, or special kinds and denominations of money to fill their domestic needs. All letters requesting shipment of money are sent by the paying teller to the bookkeeper to ascertain whether the bank or person making the request has a sufficient balance against which the shipment may be charged. The signature on the letter is compared with the signature card. The currency is then made up for shipment and turned over to the person in charge of express shipments. He puts it up in a sealed package and delivers it to the express company or post-office for shipment.

Payment of Clearing House Balances.—The paying teller in many banks is also charged with the payment of balances arising in connection with the daily clearing house operations. In some cities these balances are settled by the payment of cash or by draft on the clearing house or other bank. Since the establishment of the federal reserve system, settlements are made when possible merely by book transfers among the banks concerned through the local federal reserve bank. For example, in New York the paying teller is charged with the amount of the checks and other items accumulated from the various departments which have been sent to the clearing house. The paying teller is therefore required to account for an amount equal to that received from these various departments, and this figure becomes a debit upon his records. As explained in Chapter VII, the other members of the clearing house return or exchange the items drawn upon his bank, which items he passes upon and turns over to the bookkeepers to be charged to the proper accounts.

Since the teller has paid out an equivalent amount of cash in one form or another for these items, he credits himself with the items received and charges them to the bookkeepers. Now, if the amount he receives from the clearing house is less than the amount of the items he sent there, it is obvious that the bank has a credit balance at the clearing house. Instead of collecting this in actual money, the teller charges the federal reserve bank with the amount and credits his own bank under the head "Lawful Reserve with the Federal Reserve Bank." The banks indebted to the clearing house make provision with the federal reserve bank to charge their accounts with such amount, and the balances are thus settled without any transfer of actual money.

Disposition of Items Received in Exchange for Cash.—The paying teller's operations at the window result in an accumulation of checks and other items for which he has given cash. These items are sorted into two main groups, one consisting of checks

drawn upon the bank itself and the other consisting of those drawn upon other banks. These latter items are first entered in a memorandum book which shows the name of the bank upon which they are drawn, the indorser and the amount of each check, and then disposed of by charging them to certain other departments of the bank. For example, checks drawn upon members of the clearing house in the same city may be sent to the city collection department and ultimately to the clearing house. Such items as coupons may be sent to a special coupon collection department. The checks drawn on the bank itself are sent to the bookkeepers handling the accounts of depositors. Before sending out any of these items, the paying teller makes a record of their total amount and charges the departments to which he sends them with such amount, taking credit for them himself.

Payment of Petty Expenses and Salaries.—The functions so far discussed may be said to be characteristic of the paying operations. The paying teller frequently has charge of various incidental duties. In a small bank these may be numerous but are not likely to involve any considerable work, but in a large bank there may be a number of special clerks to assist the paying teller in performing some of the functions termed incidental.

There are, for example, a number of disbursements of cash which are made by the paying teller to meet the needs of the bank itself. Among such expenditures are those made for postage and revenue stamps, messenger fees, carfare, and various other petty matters for which it is not worth while to make separate entry on the books of the bank. The paying teller is called upon also to provide the cash for payments due to the bank's employees, such as salaries, payments of supper money for overtime, and payments of bonuses and Christmas gifts.

Certification of Checks.—Another duty which requires considerable time in certain large city banks is that of certifying

checks. The process of certifying consists in stamping the word "Certified," "Good when properly indorsed," or a similar legend upon the instrument, after which it is signed by the properly designated officer or employee of the bank. A check thus certified is an obligation of the bank, the payment of which has been guaranteed. It matters not what the status of the individual signer of the check may be, the holder of a certified check can force payment when he presents the item. The purpose of certifying items is to extend their usefulness. When a check has been certified, anyone is safe in receiving it provided the bank is solvent. The holder of the check then really has the check of the bank rather than the check of an individual or firm.

Since the bank assumes the responsibility of paying certified items, extreme care is taken to see that no checks are guaranteed unless they are good; and the bank also makes sure that the funds standing to the credit of the signer of the check shall not be drawn out before the certified check is presented and deducted from the balance. Since certified checks are practically a substitute for money, they are used widely in the settlement of stock exchange transactions; and also serve as deposits in evidence of good faith when making sealed bids or to guarantee the fulfillment of a contract. The responsibility for the certification of checks usually falls upon the paying teller unless there is a separate certification department.

The procedure in certifying a check varies somewhat in different banks but in essence it is as follows: The customer presents his check drawn either to his own order or to the order of some other party, and requests that it be certified. The paying teller ascertains from the bookkeeper whether the balance of the depositor is sufficient to cover the check. If so, he instructs the bookkeeper to hold a sufficient part of the balance to cover the check he is about to certify. He marks the check "Certified" and has the certification or guarantee signed by the proper authority. He then sends through a debit and a credit for the amount of the

check, the debit going to the bookkeeper who has charge of the account in question, and the corresponding credit to the general ledger bookkeeper, or to the certified check bookkeeper, to be credited to the account of Certified Checks Outstanding. The check itself is then handed back to the customer who disposes of it as he desires. When the check comes back to the bank for payment it does not go to the bookkeeper who has charge of the signer's account, because that account has already been charged, but to the bookkeeper who recorded the credit to Certified Checks Outstanding and who now charges this account, thus balancing the credit previously entered. The balance in the Certified Checks account shows the bank's liability to holders of certified instruments at any given time.

The Paying Teller's Daily Proof.—At the end of the day's work the paying teller makes up his proof for the purpose of ascertaining whether any errors have been made in the handling of the cash during the day and of furnishing a detailed record of the bank's cash on hand. Beginning with the balance of cash in the vault, charged to him on the preceding day, the paying teller adds the amount of the items sent to the clearing house and the amounts of cash and cash items received from the other tellers of the bank during the day. A total of these amounts furnishes the total of cash and cash items charged to him. On his credit side he has paid out some cash to other departments and he has also sent cash items to the bookkeepers and various other employees of the bank. Accordingly, on the credit side of his proof he enters the amount of the items received from the clearing house during the day, the sums of money he has sent to the other tellers of the bank, and the checks he has cashed upon his own bank during the day. The difference between these two sides of the Cash account represents the balance for the day, and the amount is entered upon the credit side of the proof. This should equal the total amount of cash and cash items on hand at the end of the day.

To put this process in somewhat simpler terms, the amount of money or its equivalent which the paying teller has at the end of the day ought to equal the amount he had at the beginning of the day plus any additions to that amount and less the subtractions made from it—as shown by the checks and other items paid either directly over the counter or indirectly through the clearing house. If this agreement is obtained, the teller may assume that the work of the department has been done correctly. If, however, the work does not prove, he must check up the items and transactions handled during the day to locate the error.

A belief that has had wide acceptance is that the daily settlements of bank tellers must be made to "balance to the penny." It is sometimes impossible to find the "difference," as the tellers call it, and in many cases the error is so small that any extended search for it would be uneconomical. An "Over and Short" account is maintained, and this is credited or debited as the difference indicates.

CHAPTER VII

CLEARING

Exchange a Primary Banking Function.—It was pointed out in an earlier chapter that one of the essential functions of a bank is to provide a mechanism of exchange. By this it is meant that the bank provides facilities whereby one person may transfer funds to another person without the necessity of sending the actual money.

This function antedated by centuries some of the activities which are characteristic of the modern bank. The bankers and money-changers in the Mediterranean trading cities of the fourteenth and fifteenth centuries obtained a large part of their profit by furnishing to traders in one city the facilities for transferring funds to persons in another city. In order to carry on this business the bankers established branch offices in the important trading centers. This extension of their operations enabled them to draw drafts or orders of payment on any branch, and these documents could be exchanged for actual money at the request of the merchant. The person receiving the draft could in turn obtain the sum called for by presenting the paper at any of the offices of the banker. For this service the bankers, of course, charged a fee, and it is said that the volume of their business and its profits ran into very large figures.

The exchange facilities which the modern bank provides vary, but the essential feature of all exchange operations is the transfer of funds from one person to another. These persons may carry on business in the same city or community or they may be at a considerable distance from each other, either within the same country or in different countries. The exchange machinery created by the bank brings them together so far as a settlement

of financial transactions is concerned. The transactions to which the term may be applied may be grouped in four main classes, varying according to the distance between the parties.

1. **Exchange in Its Simplest Form.**—From this point of view the most rudimentary use of the exchange facilities provided by a bank occurs when a payment is made by one individual to another, both of whom are depositors in the same bank. In such case the exchange or transfer is made merely by an entry on the books of the bank. For example assume that A and B are both depositors in Bank X. A gives B a check for $1,000, and B deposits the check. The exchange is made when the bank deducts from A's account the $1,000 called for by the check and adds it to the balance standing in the name of B. This sort of transaction is a very familiar one and calls for no extended discussion.

2. **Local Exchange—Clearing.**—The second type of exchange transaction occurs when the transfer is made between individuals whose accounts are in different banks in the same city. A has his account in Bank X, B has his in Bank Y. A draws a check on Bank X and gives it to B, who deposits it in Bank Y. The exchange now is made between the banks X and Y. Bank Y takes the check on Bank X and collects the money, which it credits to B's account; Bank X deducts the amount of the check from A's balance. This exchange gives rise to the process of clearing and, where there are a number of banks, the establishment of a clearing house. The machinery provided by the banks for this purpose is the subject of the discussion in this chapter.

3. **Domestic Intercommunity Exchange—Transit.**—A third form of exchange operations appears when an individual draws his check on a bank in one city and sends it to another person, who deposits it in his own bank in a distant city. Say that A

draws a check on Bank X in Boston and sends it to B, who deposits it to his credit in Bank Y in New Orleans. Upon depositing the check, B obtains from the bank in New Orleans the right to draw in actual cash the amount called for. But there still remains the question as to how Bank Y reimburses itself. It might do so in any one of several ways which will be discussed in more detail in the succeeding chapter, but the simplest way can be illustrated by assuming that both X and Y have accounts with the same bank in New York.

Bank Y now sends the check on Bank X to the New York bank, and the amount is credited to its balance with that bank. The check is at the same time charged to the account of Bank X, and is forwarded to it. When the check arrives it is charged by Bank X to the account of A. Here again there has been, in effect, a transfer of money from Boston to New Orleans by the simple process of transferring credit from one bank to another on the books of a third bank in New York. The handling of items in this manner between banks in different parts of the country is spoken of as a "transit operation," and the checks themselves are called "transit items" or "transits." The discussion of this function will be taken up in the following chapter.

4. **International or Foreign Exchange.**—The fourth kind of exchange transaction occurs when the transfer of funds takes place between individuals who are located in different countries. Such a transfer gives rise to a somewhat more complicated business which is called foreign exchange. The exchanges made within the same country are spoken of as domestic exchange transactions.

These various transfers may be made by personal delivery of the funds or instruments calling for funds, as is the case in the clearing operations; or they may be made by mail, as in the case of transit items or foreign exchange transactions; or finally, they may be made by telegraph or cable, as is the case in certain domestic and foreign exchange transactions.

The Clearing Principle.—In this chapter attention is devoted to the process of making exchanges among banks in the same community, thus bringing to view the clearing principle as it has been worked out by the banks. The clearing process consists of a joint meeting by the representatives of associated banks for the exchange of claims which the various banks hold against each other, and the payment or receipt of the difference between the claims and the obligations of each bank. If there are ten banks in a given community, each will probably in the course of its day's business receive from its depositors checks drawn upon each of the other banks. It is conceivable, and indeed it was originally the practice, for each bank under such circumstances to send a messenger to collect from the other banks the checks drawn upon them. It is clear that this method involves the employment of a considerable number of messengers, that it requires a large amount of time to collect all the items, and that there is great risk of loss.

A great saving of time is effected when the messengers from the various banks come together at a central point and each settles with every other; but this does not greatly reduce the amount of cash needed nor does it by any means result in the greatest economy of time. Further economy of time and cash is effected when, instead of settling with each other, each settles with a single outside party such as the clearing house, and each pays, instead of the amount owed to every other member bank, only the difference between the total amount owed to and the total amount due from all the other banks. This clearing principle—which is really a process of settling for differences—is carried out in businesses other than banking; for example, the members of the stock exchange and of the grain exchange greatly facilitate their operations by settling for their daily transactions through a clearing house.

Advantages of a Clearing House.—The establishment of a mechanism for clearing or exchanging checks or other items re-

sults in the following advantages for the banks and incidentally for their depositors: (1) the amount of money required to carry on the world's business is smaller; (2) a much larger volume of business can be handled than would otherwise be possible with the same number of clerks; (3) there is less danger of loss or theft than there would be if these exchanges were made by messenger; and (4) much less time is required to effect the exchanges than would be consumed if each messenger had to call at every other bank to make his collections.

Some idea of the possibility of economizing in the use of money through the operation of the clearing house may be obtained from the fact that in sixty-one years the New York Clearing House settled exchanges amounting to $2,509,034,041,053, by the use of only $117,797,140,257 in actual money. That is, the amount of money used in making settlements was only about 4.6 per cent of the total exchanges. It is said that the smallest balance ever settled at the New York Clearing House was one cent. Seven million dollars of items have been settled through the clearing house by the payment of only 10 cents. One of the Boston banks, it is said, settled a day's clearings without having any balance. It is, of course, however, extremely rare that the amount of the checks drawn on a given bank and cashed by other banks will exactly balance the amount drawn on all the other banks and cashed by the first bank.

Organization for Clearing.—The general method of organizing for clearing is to have the banks of a given community agree on a common meeting place, where their representatives gather at a regular hour to exchange the claims which each holds against the other banks of the community. The difference between the amounts owed to and by the bank in question is the amount such bank either pays or receives from the clearing house. In the smaller communities, where banks are not numerous, the expense of maintaining a building and an organization devoted exclusively

to the clearing function would be too heavy for the banks to meet. Consequently, in many communities the representatives of the different banks meet alternately on the premises of the several banks and there make their exchanges. Where the volume of clearings is large it is found desirable and economical to establish a permanent place and a permanent organization for clearing.

The Establishment of Clearing Houses.—The origin of the clearing procedure is shrouded in uncertainty. It is quite likely that bankers and others very early realized the advantages that could be obtained by meeting in a common place to effect exchanges among themselves. It is asserted that the merchants and bankers of Naples had some such arrangement as early as the fifteenth century. It is certain, however, that in 1853 the bank messengers of New York met in Wall Street to exchange checks and notes—a voluntary arrangement made by the clerks for their own convenience. As a result of this experience the representatives of fifty-two banks met November 11, 1853, and adopted a plan for the clearing of checks and the settlement of balances, and a building was obtained for the purpose. Boston established a clearing house in 1856, Philadelphia in 1858, Chicago in 1865, and St. Louis in 1868. At present nearly every town or city which has half a dozen or more banks has an arrangement for daily clearing of items.

The New York Clearing House.—Since the principle of clearing is the same no matter what may be the size of the organization, the mechanism can probably best be understood by considering the organization and operation of the most famous clearing house in the country. The New York Clearing House Association consists of some sixty banks located in the city of New York and includes the Federal Reserve Bank of New York. Until the discontinuance of the United States Sub-Treasury at New York in December, 1920, the sub-treasury also was a member. The

clearing house association is an unincorporated co-operative association, deriving its authority from the written assent of its members to its constitution.

Each member is given a number; for example, the National City Bank is number 8; the federal reserve bank is number 120; the sub-treasury was number 75. To save time, the members are referred to by number rather than by name in their relations with one another. A glance over the list of members shows that the numbers do not run consecutively; certain gaps occur in the series. This is due to the withdrawal or consolidation of various members. The vacancies are not filled and when new members are admitted they take the next new number. Another peculiarity of the association is that a city collection department, which will be described later, is organized within the clearing house. This is a department of the clearing house itself and is given the distinctive number, 200, because it stands in special relation to the members of the association.

How Membership Is Obtained.—To become a member a bank makes formal application. If this receives favorable consideration by the committee on admissions and a favorable vote of three-fourths of the members of the clearing house association who are present at the meeting when the application is presented, the bank is admitted. Each member must have an unimpaired combined capital and surplus of at least $1,000,000. The new member is required to signify in writing its assent to the constitution and to pay an admission fee which varies with the capital and surplus. For example, banks having a capital and surplus of more than $5,000,000 pay an admission fee of $7,500, while those having a capital and surplus of less than that amount pay $5,000. Members may be suspended by the joint action of the clearing house and the conference committees. They may be expelled by an affirmative vote of the majority of the members. On the other hand, a member may withdraw from the association at any time

provided it pays its share of the expenses of the association up to the time of withdrawal.

The federal reserve bank has the status of a special member. It is not required to sign the constitution, nor to furnish a weekly statement; it is not subject to the clearing house rules regarding collection charges and it has no vote. In other respects it has the status of a regular member of the association.

Clearing for Non-Member Banks.—Many banks do not have a volume of clearings sufficient to make it worth while for them to become members of the association. Provision has been made whereby such banks may arrange to have member banks clear for them. An arrangement of this sort must first have the sanction of the clearing house committee. Banks which enjoy the privilege of clearing through members are required to pay $1,500 a year, to submit to examination by the clearing house examiner, and to furnish reports to the association in the same manner as members.

The Clearing House Manager.—The administration of the clearing house association is vested in the officers and the standing committees chosen by the members in annual meeting, and guided by the constitution of the association. The president and secretary perform the functions common to similar officers in other organizations. The most important official is the manager, who is appointed annually by the clearing house committee. It has been customary to retain the same manager from year to year; in fact there have been only four incumbents of the position in the sixty-five years of the existence of the association. The manager has full charge of the clearing operations and during the period of clearing he controls the clerks and employees of the association as well as the employees of the member banks. As superintendent of the clearing house session, he maintains discipline on the floor, adjusts balances, imposes fines for violations

of the rules of procedure, keeps records of the operations of the clearing house, and performs various other duties.

Clearing House Committees.—There are five standing committees to regulate matters relating to the clearing house itself, to conferences, admissions, nominations, and arbitration. The clearing house committee has the most important functions. It provides for the maintenance of the association and draws upon the members for their share of the expenses. It fixes the salaries of all the employees except those of the manager and assistant manager. It may examine a member bank and, if it deems such a course necessary, may require that bank to deposit securities to insure the payment of its balances resulting from the clearings. Subject to the approval of the association, the clearing house committee is empowered to establish a scale of fines for errors and to provide rules to govern proceedings when they are not provided for in the constitution. It provides for the issuance of clearing house certificates to members and fixes the regulations therefor, and it legislates upon the subject of collections outside New York City. All applications of banks for membership or for the privilege of clearing through members are made to this committee. This committee, with the consent of the conference committee, may temporarily suspend members of the association when it is deemed necessary.

The expenses of the association, except those arising from the work of the department of examinations, are apportioned among the members pro rata according to the average amount of clearings sent by each member to the clearing house during the preceding year, with a minimum charge of $1,000 a year. The expenses of the department of examination are assessed separately against each member on the basis of gross assets.

Organization of Clearing Work.—The organization for effecting clearing consists of a few permanent employees of the clearing

house and a varying number of representatives from the member banks who come to the clearing house for the purpose of making the exchanges. A bank's force for making clearings may consist of as many as eight men, according to the number of messengers, porters, and clerks required by the volume of the work.

The essential operations of clearing may be reduced to two; the delivery of items to the banks upon which they are drawn; and the receiving and recording of these items by the banks in question. Reduced to its simplest form, the clearing house operation of a given bank may be performed by two clerks, a delivery clerk and a settling clerk, to whom are delegated the tasks mentioned above.

Items Handled by Clearing House.—The items which may be sent by a bank through the clearing house include in general all cash items payable by the banks which are entitled to use the facilities of the association. All ordinary checks, certified checks, clean drafts and bills of exchange (a clean draft is one which is not accompanied by a bill of lading or other shipping papers), notes and accepted drafts which are due and which are drawn upon or payable at clearing house banks, are regularly sent through the exchanges. Items which bear restrictive or qualified indorsements, such as "For collection," or "For account of," are excluded unless the sending bank guarantees all indorsements which precede its own.

In practice it is impossible for the sending bank to examine the indorsements of every one of the thousands of checks which it daily sends through the exchanges. Hence it is the custom to guarantee all previous indorsements on all clearing house items. Furthermore, the association requires that all items to be cleared be indorsed by the sending bank, with an accompanying acknowledgment of receipt of payment through the clearing house. The member banks use more or less uniform indorsement stamps which both guarantee previous indorsements and acknowledge

receipt of payment through the clearing house. These indorsements are stamped on the checks by an indorsing machine in the case of banks which handle a large number of items.

Preparation of Checks for Clearance.—With the member banks the process of preparing items for clearing is practically continuous. Beginning just after ten o'clock in the morning when the day's regular clearing sessions are over, the items which are to be sent to the clearing house for exchange are sorted by the various departments and accumulated in the assembly rack department, or such other department as is charged with the work of preparing for the clearing. Many of the items come from the mail teller's department. In large banks a force of men is at work all night opening the mail and sorting the items according to the manner in which they are to be handled. Many items will be received in the morning mail and some will be taken in by the receiving teller and other employees. When large items are taken in by the receiving teller before ten o'clock, special effort is made to send them to the clearing house so as not to lose a day's interest on the amounts. The items for the clearing house are sorted according to the banks which are to make payment, and are enclosed in a standard form of envelope, to the outside of which the list of contents is attached.

Clearing House Forms.—The clearing house requires certain forms to be used in handling the day's business:

1. The exchange slip, which lists the items to be delivered to a given bank. One of these slips is made up for each bank against which claims are presented, and the slip is then attached to the envelope containing the claims or exchanges, as they are called.

2. The small ticket, which shows the name of the bank against which the claims are presented, the name of the claimant, and the aggregate claim brought. One of these tickets is made out and presented to each bank in the clearing house. The total of all

these tickets presented to a given bank is the amount of the indebtedness of that bank to the clearing house for the day.

3. The first ticket (Form 8), which gives the date, name, clearing house number of the claimant bank, and the aggregate of exchanges brought by it for the day. This record is for the use of the proof clerk of the clearing house, and represents, it will be seen, the total claim of a given bank against the clearing

New York Clearing House.

No. 8. New York Clearing House.

May 3 1921

Credit THE NATIONAL CITY BANK, $74,842,144.32

C. L. Danielson Settling Clerk.

Form 8. Clearing House First Ticket. (Size 8½ x 3½.)

house for items drawn upon other member banks which it has cashed.

4. The settling clerk's receipt—a form containing the names of the clearing house banks arranged according to number on the left side and a column to the right for the total claims against each and the signatures of the clerks who receive the claims. This form is for the purpose of securing the receipt of the banks against which claims are presented. All but the column for signatures is completed in preparation for the clearing.

Clearing House Sessions.—The exchanges are taken to the clearing house at one of its two regular sessions, held at nine and at ten o'clock. At the nine o'clock session most of the members meet to exchange whatever items they have been able to prepare for clearing up to that time. Inasmuch as most of the banks operate night forces, or assembly racks, a large part of the day's

exchanges are made at this time. No forms are exchanged and no settlement is made. This session is held merely to give the banks a start of one hour upon the incoming checks. The clerks and bookkeepers of each bank are thus enabled to begin their work shortly after nine o'clock, instead of being forced to wait until after ten, and therefore any items which must be returned to the sending bank because of irregularity will be discovered in time to return them the same day.

The Delivery and Receipt of Items.—The main session of the clearing house begins at ten o'clock. Shortly before that hour a representative of each bank, who is known as the bank's settling clerk at the clearing house session, takes charge of the items prepared in the morning together with the forms necessary for making the exchanges. Inside the clearing house, everything is arranged so as to insure the rapid transaction of the work and the elimination of confusion. A desk is assigned to each settling clerk. These desks are arranged in rows in the order of the bank's clearing house number. The settling clerk takes his station behind the desk, while the delivery clerk with his envelopes, exchange slips, and small tickets, together with the forms for obtaining the receipts of each bank to which he makes delivery, takes his place in front of the desk.

Promptly at ten o'clock the signal for starting the exchange of items is given by the clearing house manager. Each delivery clerk moves forward past the desk of each of the other banks, and as he passes he leaves with the settling clerk stationed there the envelope containing the items, exchange slip, and the small ticket for that particular bank. He obtains the settling clerk's receipt on his receipt form for the amount of the claim against the bank. After he has delivered his packages and obtained receipts from all the other banks, he returns to his own desk. Each bank has now delivered to the other banks all the claims held against them.

The Work of the Settling Clerk.—The settling clerk of each bank has now received all the claims which other banks have against his institution. His associate, the delivery clerk of that bank, takes all these items back to the bank, where work is immediately begun upon them. The settling clerk remains at the clearing house and makes up his statement (Form 9).

The credit column of the statement sheet of each bank shows the claims which have been brought by it to the clearing house, this part of the statement having been prepared before coming to the clearing house. The settling clerk completes the statement by entering from the exchange slips attached to the envelopes containing the exchanges, the amounts which have been presented against his bank. The two columns are then added and the difference indicates the amount owed by his bank to the clearing house, or the amount owed by the clearing house to the bank.

The settling clerk then makes out a second ticket, showing the bank's debit for the amount of exchanges presented against it, its credit for the amount brought, and the amount and character of its balance. This second ticket is given to the settling clerk of the clearing house.

The Daily Clearing House Proof.—In the meantime while the settling clerk is making up his second ticket, the proof clerk of the clearing house has started work on a proof of the day's work. The columns of the proof sheets are headed "Due Clearing House," "Banks Dr.," "Banks Cr.," "Due Banks." When the settling clerks of the various banks first appear at the clearing house, they send their first tickets to the proof clerk. From these he prepares the "Banks Cr." column of his proof sheet. This shows the total claim, as was pointed out before, of each bank against the clearing house. When the second tickets are sent to the proof clerk, he prepares the other columns of his proof. One of these columns, "Banks Dr.," shows the amount of each bank's total indebtedness to the clearing house; another, "Due banks,"

No. 8 THE NATIONAL CITY BANK OF NEW YORK.

Settling Clerk's Statement. May. 3, 1921

No	BANKS	TOTAL DEBIT		No.	BANKS	CR.
1	Bank of N. Y. Nat'l Bk'g Ass'n,	2,529,506	30	1	2,256,505	08
2	Bank of the Manhattan Company,	4,030,444	96	2	4,295,032	20
3	Merchants' National Bank,	391,181	87	3	757,841	11
4	Mechanics' & Metals Nat'l Bank,	5,412,681	99	4	4,809,970	65
6	Bank of America,	3,384,961	87	6	2,316,576	22
12	Chemical National Bank,	827,113	80	12	976,086	88
59	East River National Bank,	34,815	82	59	45,871	23
63	Second National Bank,	398,768	45	63	118,791	87
65	First National Bank,	4,245,688	71	65	2,709,754	51
67	Irving National Bank,	1,098,224	70	67	1,387,422	73
70	Bowery Bank,	9,559	63	70	7,947	14
71	N Y County National Bank,	50,639	44	71	24,030	05
72	Continental Bank,	650,001	33	72	814,519	48
74	Chase National Bank,	5,104,457	52	74	5,654,482	58
75	Asst. Treas. U. S. at N. Y.,	91,036	37	75	145,306	94
76	Fifth Avenue Bank,	510,941	93	76	50,892	16
		12,194,133	90			
77	Commercial Exchange Bank,	14,386	11	77	11,694	78
78	Commonwealth Bank,	11,574	23	78	5,900	02
30	Lincoln National Bank	66,859	76	80	164,909	02
81	Garfield National Bank,	46,625	29	81	45,674	92
82	Fifth National Bank,	20,979	38	82	38,557	33
85	Seaboard National Bank,	1,300,758	19	85	1,609,718	41
91	Liberty National Bank,	1,851,865	20	91	1,077,030	05
92	N Y Produce Exchange Bank,	144,111	27	92	87,870	49
96	The State Bank,	113,882	57	96	39,377	83
99	Coal & Iron Nat'l Bank,	223,015	12	99	126,623	90
100	Union Exchange Nat'l Bank,	41,703	06	100	88,090	37
		3,835,760	18			
					72,637,398	10
		28,203,756	00	Cr. Bal.	2,204,746	22
		17,551,180	10			
		3,835,760	18			
		12,194,133	90			
		13,057,314	14			
		74,842,144	32		74,842,144	32

Form 9. Settling Clerk's Statement. (Size 8 x 21¼.)

shows the balance due to each bank from the clearing house; and another, "Due Clearing House," shows the balance due from each bank to the clearing house. Some banks will show a balance due to them, whereas the rest will be indebted to the clearing house.

The proof of the clearing house operations is completed when the total of the first column equals that of the fourth column, and the total of the second column equals that of the third. The total of the "Banks Cr." column should equal the total of the "Banks Dr." column, because every claim which is credited to a bank must be debited to some other. Similarly the first and fourth columns must be equal or there would be a balance or deficit for the clearing house after all the banks have obtained settlement. This cannot be the case, because the clearing house possesses no claims of its own but merely provides a place and a process by which the banks can settle with each other. The amounts which are due to the clearing house are in turn due from it to the creditor banks, and hence the total amount due to the clearing house must equal the total amount due to the banks. If a difference exists, the amount is announced and the clerks search for the source of error. Fines are imposed upon those who are responsible for the error, and these fines are increased in amount if the error is not located within a specified time. When the proof is completed the manager reads the balance for each bank in thousands of dollars, and the balance is kept by the settling clerks to serve as a general statement of the day's clearings for the use of the officers of their respective banks.

The Payment of Clearing House Balances.—With the completion of the proof, the day's business in the clearing house has been accomplished. There remains, however, the necessity of settling for the balances. Some banks are indebted to the clearing house, while others are entitled to receive funds from it. Formerly these balances were settled by the debtor banks bringing to the clearing house actual cash or prescribed equivalents.

At a later hour the creditor banks used to appear and receive in cash the amount due to them. This system was both cumbersome and dangerous since it involved the expense and risk of carrying millions of dollars in cash through the streets of the city each day. To avoid this risky and cumbersome method, clearing house gold certificates were adopted as a means of settling balances. The member banks deposited gold with the clearing house and against this gold certificates were issued. These certificates were accepted in the settlement of balances due at the clearing house.

Since the establishment of the federal reserve system the adjustment of balances has been made through the Federal Reserve Bank of New York. Under this system each member bank of the New York Clearing House Association which is not a member of the federal reserve system is required by clearing house rules to keep a balance on deposit with the local federal reserve bank or to make other arrangements for federal reserve funds with which to settle its balances. Those banks which are members of the federal reserve system are required by law to keep balances with the New York Federal Reserve Bank and hence this bank holds balances available for the use of every clearing house member.

After the exchanges have been effected, the clearing house manager sends to the federal reserve bank a certified list of the day's balances. By special agreement between the clearing house association, the member banks, and the Federal Reserve Bank of New York, a book entry is made whereby the federal reserve bank debits the accounts of all clearing house debtors, and credits the accounts of all the creditor banks for the amounts of their respective balances. Thus each creditor bank receives settlement for its balance in the form of an additional deposit to its credit with the local federal reserve bank. As for the debtor banks, the balance which each has to its credit in the federal reserve bank undergoes a reduction.

Other Methods of Settlement.—While the New York Clearing House Association makes use of the federal reserve bank for the purpose of the settlement of balances, many communities have no such facilities. In such places settlement is still made either by: (1) the transfer of actual money; (2) drawing upon a gold settlement fund deposited at the clearing house; (3) drawing drafts for the amount of the balance due upon some correspondent bank in a central reserve city; or (4) the use of clearing house due bills, or by some similar method. A clearing house due bill is an instrument which indicates that the given bank has credit in the clearing house for a certain sum as represented by its balance. This due bill is kept by the bank and may be used the next day or at any succeeding period to cancel its indebtedness to the clearing house when balances turn against it, as from time to time they do.

Errors, Adjustments, Fines.—It is inevitable that, in the handling of the large number of items exchanged daily in the New York Clearing House, a considerable number of transactions should arise requiring an adjustment of some sort to be made. Many checks are paid which upon closer examination the drawee banks are unwilling to pay, either because of insufficient funds, unsatisfactory signature, stop-payment order, or some other difficulty. Many items, besides, are sent to the wrong banks. For the adjustment of such errors the procedure is outlined by the clearing house association. All errors must be adjusted by the banks themselves, the clearing house association assuming no responsibility for them. The adjustment must take place on the same day on which the errors are made. Certain fines are prescribed by the clearing house association; these are imposed and collected from the offending banks, when items have been sent to the wrong banks, for the benefit of the banks which have been put to the inconvenience of returning the items. For the convenience of members, the association holds a special daily session at three

o'clock for the return of items contained in the morning exchanges for which payment is refused.

Other Functions of the Clearing House Association.—Besides providing the machinery for effecting exchanges, as has been described, the clearing house association engages in certain other activities. The most important of these are: the collection of certain items payable at city and country banks; the establishment of certain uniform practices among members designed for their mutual protection and benefit; mutual support in time of stress; examination of member banks from time to time; requirement and publication of reports of condition of its members.

The City Collection Department.—The collection of items payable at certain city and country banks was a natural development of the work of the clearing house, with its machinery for effecting exchanges among the members. The beginning was made with the establishment of a country collection department, the function of which was to receive and collect for its members items payable at out-of-town banks. This department served a very useful purpose, but, after the establishment of the federal reserve system and the extension of the collection facilities of that system, the work of making country collections was largely taken over by the federal reserve bank, and the country department of the clearing house was closed. More recently a city collection department has been organized and this is in successful operation. The function of this department is to make collections for member banks of items payable at certain city banks not in the association.

Uniform Regulations for Member Banks.—Among the uniform regulations which have been adopted for mutual benefit and protection, the most important have to do with the rate of interest to be allowed on depositors' balances, the establishment of collection and exchange charges, and the standardization of re-

quirements as to the amount and method of calculation of cash reserve to be kept against deposit liability. The clearing house association establishes from time to time the maximum rate of interest which member banks may pay on depositors' balances. The reason for so doing is to prevent banks, through force of competition, from paying rates of interest so high as to eliminate legitimate profit from such accounts. It is recognized that the payment of interest on balances is a matter calling for coöperative rather than individual action.

The association recognizes three types of deposits: (1) deposits or certificates of deposit payable on demand or within 30 days, due to any bank or banker located in the United States or Canada, except a mutual savings bank located in the New York Federal Reserve District; (2) deposits or certificates of deposit due to any mutual savings bank located in the New York Federal Reserve District or to any concern other than a bank; and (3) time deposits consisting of all deposits payable after 30 days.

Interest Rates on Depositors' Balances.—With respect to demand deposits due to banks and bankers, the rate payable is based upon the discount rate for 90-day commercial paper at the New York Federal Reserve Bank. For example, when the discount rate is 2 per cent or less, clearing house banks are permitted to pay a maximum rate of 1 per cent per annum on such balances. For each ½ per cent in excess of 2 per cent which the federal reserve rate shows, clearing house banks may increase their rates to depositors by ¼ per cent, except that the maximum rate to be allowed depositors may not under any circumstances exceed 2¼ per cent per annum. The maximum rate which can be allowed on deposits of mutual savings banks in the New York District, or to individuals, as well as the rate on time deposits, has been fixed at 3 per cent on the smaller and 3½ per cent on the larger class of deposits.

Regulation of Exchange Charges.—Exchange charges are likewise regulated in the interest of members. The tendency among competing banks located in the leading collection centers is to charge a low rate of exchange on country items; if possible, no charge at all is made. To make the collecting machinery of its members self-supporting, the association has established the minimum rates of exchange which must be collected from depositors for transit items deposited by them.

Regulation of Reserves.—A third direction which the effort at mutual protection takes is in connection with the regulation of reserves. The necessity for this action grows out of the fact that some of the members of the clearing house association have their reserve requirements fixed by the Federal Reserve Act, whereas other members are operating under state laws and are therefore not required to carry the same percentage of reserve. While the clearing house rules do not attempt to change the legal requirements as to the reserve which the members must carry, they do specify a method for computing the amount of net demand deposits upon which the reserve is to be figured.

The member banks are not permitted to deduct from the total deposits those secured by the deposit of outstanding unmatured stocks, bonds, or other obligations of the state or city of New York, or deposits to the amount of the stocks, bonds, or other obligations of the state or city of New York owned and held by the bank, before computing their percentage of reserve. The rules also provide that all required reserve other than that which is in the form of cash on hand must be maintained in the form of a deposit with the New York Federal Reserve Bank, or in some bank which is a member both of the federal reserve system and the clearing house association, or with any other member of the association which maintains in the Federal Reserve Bank of New York the reserve required for member banks.

STATEMENT OF THE MEMBERS OF THE NEW YORK CLEARING HOUSE ASSOCIATION

FROM REPORTS AS REQUIRED UNDER ARTICLE III OF THE CONSTITUTION.

For Week Ending Saturday, October 23, 1920.

Nos.	CLEARING HOUSE MEMBERS	*CAPITAL	*NET PROFITS	Loans, Disc'nt Investments etc. Average	CASH IN VAULT Average	Reserve with Legal Depositories Average	NET DEMAND DEPOSITS Average	TIME DEPOSITS Average	National Bank Circulation Average	Nos.
	MEMBERS OF FEDERAL RESERVE BANK									
1	Bank of New York N. B. A.	$2,000,000	$7,167,600	$48,468,000	$ 797,000	$ 4,676,000	$33,817,000	$3,689,000	$771,000	1
2	Bank of the Manhattan Co.	5,000,000	16,199,100	135,879,000	2,993,000	13,603,000	100,685,000	13,859,000	.....	2
4	Mechanics' & Metals Nat. Bank	10,000,000	16,512,800	213,503,000	10,255,000	20,014,000	153,885,000	4,126,000	1,000,000	4
6	Bank of America	5,500,000	6,044,300	60,243,000	2,114,000	7,595,000	57,459,000	1,548,000	..	6
8	National City Bank	‡ 40,000,000	‡ 64,489,200	589,553,000	13,724,000	61,553,000	(a) 592,392,000	41,716,000	1,426,000	8
122	Columbia Bank	2,000,000	1,542,100	23,553,000	728,000	3,111,000	22,570,000	114,000	......	122
123	Equitable Trust Co.	12,000,000	17,620,200	168,739,000	1,831,000	19,007,000	(e) 176,337,000	14,645,000	......	123
	STATE BANKS NOT MEMBERS OF FEDERAL RESERVE BANK									
17	Greenwich Bank	1,000,000	1,860,000	18,363,000	2,613,000	1,783,000	19,099,000	3,000	......	17
70	Bowery Bank	250,000	844,100	5,721,000	718,000	341,000	5,679,000	.....	......	70
96	State Bank	2,500,000	2,331,700	70,788,000	3,483,000	2,072,000	30,294,000	40,869,000	......	96
	TRUST COMPANIES NOT MEMBERS OF FEDERAL RESERVE BANK									
106	Title Guarantee & Trust Co.	6,000,000	12,281,900	48,882,000	1,056,000	3,710,000	31,509,000	1,105,000	......	106
110	Lawyers Title & Trust Co.	4,000,000	6,325,200	27,312,000	981,000	1,448,000	16,080,000	334,000	......	110
	TOTALS:									
	Members Federal Reserve Bank	262,900,000	460,438,500	5,274,793,000	95,195,000	547,402,000	† 4,084,793,000	246,810,000	34,673,000	
	State Banks, not members of Federal Reserve Bank	3,750,000	5,035,800	94,872,000	6,814,000	4,196,000	55,072,000	40,872,000	......	
	Trust Companies, not members of Federal Reserve Bank	10,000,000	18,607,100	76,194,000	2,037,000	5,158,000	47,589,000	1,439,000	......	
	Aggregate 52 Members	276,650,000	484,081,400	5,445,859,000	104,046,000	556,756,000	† 4,187,454,000	289,121,000	34,673,000	
	COMPARISONS			Decrease	Decrease	Decrease	Decrease	Increase	Increase	
				40,275,000	632,000	7,091,000	14,421,000	6,453,000	126,000	

*As per official reports.
25 National, Sept. 8, 1920.
13 State, Sept. 30, 1920.
14 Trust Co's, Sept. 30, 1920
‡ As of Oct. 5, 1920

(a)	Includes Deposits in Foreign Branches $130,424,000, not included in total footings:	Balances carried in banks in foreign countries as reserve for such deposits $47,945,000
(b)	" " " 3,510,000;	" " " " " " " 243,000
(c)	" " " 104,789,000;	" " " " " " " 7,375,000
(d)	" " " 19,223,000;	" " " " " " " 3,679,000
(e)	" " " 23,142,000;	" " " " " " " 7,705,000

(Bills Payable, Rediscounts, Acceptances and other Liabilities, $1,277,657,000)

				Reserve required on Net Demand Deposits,	$531,023,090					
				" Time "	7,404,300					
Members Federal Reserve Bank:	. . . .		Reserve in Depository,	$547,402,000	" Demand and Time Deposits	538,427,390	Excess,	$ 8,974,610	Decrease,	$5,675,790
State Banks, not members of Federal Reserve Bank..	Cash Reserve in Vault:	$6,814,000	" "	4,196,000	" " Deposits,	9,912,960	Excess,	1,097,040	Increase,	17,740
Trust Companies, not members of Federal Reserve Bank	" "	2,037,000	" "	5,158,000	" "	7,138,350	Excess	56,650	Decrease,	73,050
Totals	" "	$8,851,000	"	$556,756,000	" Total Net "	$555,478,700	Excess,	$10,128,300	Decrease,	$5,731,100

ACTUAL CONDITION THIS DAY

TOTALS:								
Members Federal Reserve Bank			5,232,161,000	93,072,000	507,266,000	† 4,037,302,000	249,250,000	34,691,000
State Banks, not members of Federal Reserve Bank......			95,835,000	6,923,000	4,185,000	56,059,000	40,990,000	......
Trust Companies, not members of Federal Reserve Bank			77,026,000	2,056,000	5,242,000	48,212,000	1,485,000	......
Aggregate, 52 Members........			5,405,022,000	102,051,000	516,693,000	$4,141,573,000	291,725,000	34,691,000
COMPARISONS..................			Decrease	Decrease	Decrease	Decrease	Increase	Decrease
			90,843,000	1,207,000	64,891,000	112,935,000	296,000	34,000

(Bills Payable, Rediscounts, Acceptances and other Liabilities, $1,279,710,000)

				Reserve required on Net Demand Deposits,	$524,849,260					
				" Time "	7,477,500					
Members Federal Reserve Bank:	. . . .		Reserve in Depository,	$507,266,000	" Demand and Time Deposits,	532,326,760	Deficit,	$25,060,760	Decrease,	$50,353,910
State Banks, not members of Federal Reserve Bank...	Cash Reserve in Vault:	$ 6,923,000	" "	4,185,000	" " Deposits,	10,090,620	Excess,	1,017,380	Increase,	107,260
Trust Companies, not members of Federal Reserve Bank	" "	2,056,000	" "	5,242,000	" " "	7,231,800	Excess,	66,200	Increase,	13,450
Totals	" "	$8,979,000	" "	$516,693,000	" Total Net "	$549,649,180	Deficit,	$23,977,180	Decrease,	$50,233,200

Clearings for Week ending	October 23, 1920,	$4,852,879,313.82	Balances for Week ending	October 23, 1920,	$545,224,313.56	f U. S. Deposits deducted $87,597,000
" " "	October 16, 1920,	x 4,506,264,539.44	" " "	October 10, 1920,	x 480,844,349.65	g U. S. Deposits deducted 64,919,000
Clearings this Day x 5 Days	October 23, 1920,	809,477,633.16	Balances this Day	October 23, 1920,	68,584,624.62	† Deposits in Foreign Branches not included.

Form 10. Statement of Condition of Clearing House Banks.

Clearing House Loan Certificates.—Another activity of the clearing house association is to give mutual support in time of stress. In the past this has taken the concrete form of the issue of loan certificates to members in exchange for the pledge of certain of the assets of the banks. Periods of financial stress are accompanied by an abnormal demand for money. Before the establishment of the federal reserve system the banks of New York could obtain money to satisfy these demands only from their own vaults, and as their cash began to run low the problem of conserving the supply became a pressing one. A considerable amount of cash was used in settlement of clearing house balances. A scheme was devised to substitute clearing house loan certificates for cash in the settlement of balances. Under this system a bank which was in need of funds took to the clearing house bonds, commercial paper, or other collateral, and applied for a loan of clearing house certificates. A committee of the association passed upon the collateral and, if satisfactory, clearing house loan certificates which were the joint obligations of all the members of the association were issued against it. These could be used in lieu of cash in transactions with the clearing house, and the supply of cash was thus retained for other purposes.

Bank Examinations.—Still another activity of the association is that of maintaining watch over the condition of member banks. It does this in two ways: by examining the banks from time to time, and by calling for frequent reports from them. An examination department is maintained, the function of which is to examine and report on the condition and practices of each member bank at least once a year. In addition, special examinations can be made at the discretion of the clearing house committee, as, for example, when any member bank undergoes a change of management or is merged with another bank. Of course, these examinations are in addition to those made by public officials.

Weekly Reports of Member Banks.—In addition to submitting to clearing house examination, every bank which clears through the association, except the federal reserve bank, is required to furnish a weekly report of its average daily condition, as well as a statement of its actual condition at the close of business on Friday. These reports contain the total of loans, discounts and investments, reserves, deposits, and circulation of the banks. They give the association information regarding the standing of each member and thus serve as a check upon the condition and practices of each. They are combined into a weekly statement of clearing house banks (Form 10), and are published in the financial columns of the daily papers. Since they give an up-to-date picture of the financial condition of the banks in the most important commercial center, they may be accepted as reflecting to a very great extent the banking and financial condition throughout the country.

CHAPTER VIII

TRANSITS

Use of Checks for Transferring Money.—The third class of exchange facilities which the banks furnish is in connection with the use of checks for payments between persons located in different towns or cities. With the increase in the number of banks to the point where almost every fair-sized town has one or more such institutions and with the great complexity of the products of different sections of the country, necessitating the modern system of the division of labor upon which system the satisfaction of human wants depends, there has been a marked increase in the use of bank checks for the handling of commercial transactions. It has been estimated that from 90 to 95 per cent of all commercial transactions are effected by the use of checks.

Convenience and Economy in Remitting by Check.—When a merchant in Ohio buys shoes from a manufacturer in Massachusetts he usually pays his bill by drawing a check on his local bank and mailing that instrument to the manufacturer. He can, however, buy a draft from his local bank drawn upon its account in a New York bank and can send this instrument to the shoe manufacturer; but this involves a little more trouble and may cost him something if his local bank makes a charge for the issue of the draft. Another reason why he may prefer to use his own check is that the charge against his account will not occur until the check is returned from Massachusetts through banking channels. This may require four or five days and he will thus have the use of his money for some days after he has paid his bill. If he buys a draft from his bank he must pay for it immediately. For these reasons and because of greater convenience as to denomination

and less likelihood of monetary loss, the check has become the customary medium of exchange, and bank checks have become almost as common as paper money.

While the Ohio merchant in the illustration completes his part in the transaction easily, there still remains something to be done. Before the bank in Massachusetts, which pays the holder of the check the amount specified, gets its money, it must collect the check.

The Collection of Cash Items.—The use of the word "collecting" or "collection" as referring to the collection of cash items may cause confusion, inasmuch as the word "collection" is also used in a technical sense to indicate another kind of banking activity, as for example, in connection with items known as collection items and the collection department. As was pointed out in Chapter IV dealing with receiving operations, a broad distinction exists between cash items and collection items, the latter being those checks, notes, drafts, or other instruments which are not accepted as cash but for which a receipt is given pending conversion into cash. The bank acts in such cases in the capacity of agent for the depositor of the collection items. When, on the other hand, items are accepted as cash the bank gives the depositor immediate credit and usually permits him to draw out the amount called for at any time. But these items must also be converted into cash, and the processes of converting checks and other cash items into actual cash or funds subject to the order of the bank is spoken of as the collection of cash items.

Transit Items and Collection Items.—The previous chapter dealt with the collection of cash items which are payable in the same city. The present chapter deals with the collection of cash items payable in different cities. These items are sometimes spoken of as country items, or foreign items, or transit items.

The transit department does not usually handle collection items; this work is performed by a separate department. Checks

or other instruments which seem to be properly grouped in the class of cash items may be accepted only for collection because of certain conditions which make the bank doubtful whether they will be settled for in cash immediately upon presentation at the place of payment. Thus, for example, if a check is postdated, or if it appears that it has been tampered with, or if it has previously been presented and dishonored because of insufficient funds, the receiving bank may not wish to assume any responsibility for its payment and therefore accepts it only for collection.

It might be said in a general way that those items which are not accepted for collection and those which are not available for exchange through the clearing house are transit items. In the case of the New York banks, however, there is an exception to this classification. Certain items which are spoken of as "trusts" are not handled by the transit department although they are neither received as collection items nor are they cleared regularly through the clearing house association. The name "trusts" is given to those cash items which are drawn upon institutions reached by the city collection department of the New York Clearing House.

In 1917 the New York Clearing House Association began to make collection of items drawn upon certain non-clearing banks, individuals, firms, and corporations. These banks and individuals are those against which the heaviest collections normally had to be made by the member banks. Each bank prepares such items and takes them to the clearing house at ten o'clock. The items are sorted according to the person or institution upon which they are drawn and placed in an envelope to which is attached a list indicating the contents. A receipt is obtained from the clearing house for these items, and the association then prepares a regular form of route sheet upon which is entered the amount to be collected from every drawee bank. The city collection department of the clearing house delivers these envelopes to the banks upon which the items are drawn, and obtains checks drawn

upon clearing house banks for such items. At the regular session of the clearing house at ten o'clock the next day, the receiving bank presents its receipt for the items which were presented by it on the previous day and clears this sum in the regular way. If any of these items have been returned unpaid they are deducted by the clearing house collection department from the claim of the receiving bank and the balance is then paid. The funds arising from the collection of trusts are thus available the day after they have been deposited.

The Transit Department and Its Banking Connections.—In some banks the collection of transit items is not heavy enough to require the establishment of a separate department, but in a large bank the work is handled by a special transit department. For a correct understanding of the process of collecting such items a knowledge of interbank relations is necessary.

Every bank maintains a running account with one or more other banks. Before the establishment of the federal reserve system it was customary for the banks in small towns and rural districts to maintain accounts with one or more banks in their nearest large cities. These city banks in turn maintained accounts with the banks in one or more of the three main centers, New York, Chicago, and St. Louis; and this practice has very largely continued although the establishment of the federal reserve system has modified it in some slight respects. Hence it is correct to say that practically every bank in the country has direct or indirect connections with the leading banks in the chief cities of the country.

Correspondent Banks.—Banks having direct connections with each other refer to each other as correspondents. Thus a Des Moines bank refers to the Continental and Commercial Bank of Chicago as its Chicago correspondent, and to the National City Bank of New York as its New York correspondent. Many of the

banks in the larger cities make special efforts to secure accounts of out-of-town banks. The accounts are opened under special agreements which specify each bank's obligations and fix the remuneration to be obtained from the collection of transit items. These agreements are filed with the transit department. In general, the out-of-town bank agrees to receive items drawn upon specified banks, including those drawn upon itself and upon other banks in a more or less extended territory. It is agreed that certain rates of exchange may be charged by the collecting bank. The country correspondent agrees to maintain with the city bank a certain average balance on which it usually receives a specified rate of interest.

Service of a City Correspondent.—Such accounts have been maintained for three main reasons: First, until the passage of the Federal Reserve Act the country banks were permitted to count as part of their legal reserve their balances with the city correspondents. Hence it was more profitable for a Des Moines bank, for instance, to deposit all of its reserve above what it needed at home with the New York or Chicago bank than it was to keep the funds actually in its own vaults, for the city correspondents paid interest on such balances, whereas, if the money had been kept in the bank's own vaults no interest would have been received.

A second advantage in carrying such accounts was that they enabled the interior bank to sell drafts on the city correspondents to local customers. It often happens that manufacturers or jobbers refuse to accept local checks in payment of goods sold, but demand payment by New York or Chicago draft which will be readily accepted as cash at par when deposited. For providing this means of payment the interior bank sometimes collects a small fee called exchange, and in the case of some banks this is a very profitable portion of their business. The third reason for maintaining an account with a city bank is that the city correspondents may be used as agencies to collect the transit items

which the interior bank receives. Every bank in the course of its day's business receives checks drawn on banks in other places. Some of these banks may be near at hand and the items may be

THE NATIONAL CITY BANK OF NEW YORK

We enclose for collection items as listed below:

UNLESS OTHERWISE INSTRUCTED.—Do not hold collections for the convenience of parties. Surrender documents attached to drafts only on payment of same. PROTEST and RETURN without delay all dishonored paper. Telegraph non-payment of all items over $500.

DO NOT PROTEST ITEMS $10.00 OR UNDER.

To
CITIZENS AND SOUTHERN BANK
SAVANNAH, GEORGIA.

10/28/21 FOD

64 808	45.67
64 356	123.42
64 732	234.67
64 892	134.73
BANK OF VIENNA, VIENNA GA.	1.01
PEOPLES BANK, SUMMIT GA.	5.87
	545.37c

Do Not Protest Items bearing the symbol (N.P. 1-8), or a similar authority of a preceding endorser.

Form 11. Remittance Letter to Correspondent Bank. (Size 6 x 7.)

collected by local arrangement. But checks which are payable at distant places have been almost invariably collected through city correspondents. Form 11 is a specimen of a remittance letter sent with items for collection.

Reciprocal Agreements between Correspondent Banks.—The arrangement between banks is usually a reciprocal one; that is, a bank in Manchester, New Hampshire, may send to its Boston correspondent all the items it receives which are payable south and west of Boston; and in exchange it may agree to collect all the items that the Boston bank receives which are payable anywhere in New Hampshire. To look into the matter somewhat further for the sake of clarity, it may be asked, assuming the reciprocal arrangement as just described, how does the Manchester bank, for example, collect the items which the Boston bank sends to it?

There is, of course, always the possibility of collecting by sending the cash items direct; that is, if a check sent to the Manchester bank were payable at Portsmouth, and assuming that the Manchester and Portsmouth banks did not carry accounts with each other, the item might be sent to Portsmouth direct with the request that the paying bank remit the amount by means of a draft on New York or Boston. This, however, would usually be distasteful to the Portsmouth bank because it would mean that its interest-bearing account in New York or Boston would be reduced immediately, whereas if the check were sent in the usual course through one or more other banks, thus reaching Portsmouth indirectly, there would be a longer time during which the bank would not have to pay the check, and therefore the bank would gain interest for this period of time on the amount of money involved. To compensate itself for this possible loss of interest and for the trouble and expense it suffered in building up its balance in New York or Boston, the Portsmouth bank upon remitting would deduct a small fee, called exchange, from the face of the item. To avoid this charge the Manchester bank would usually prefer a cheaper roundabout method of collection.

The Clearing Process in Transit Operations.—If the decision has been made to collect indirectly, how does the Manchester bank obtain its funds? It does so by an extension of the clearing

principle—by a process of offsetting the amounts it owes with the amounts owed to it by other banks. While it was assumed that the Manchester bank has no direct connection with the Portsmouth bank, it is altogether likely that the bank in Portsmouth and the bank in Manchester each have a running account at a bank located conveniently for both of them. Accordingly the Manchester bank sends the items to this third bank and asks that they be credited to its account. This bank in turn charges the checks to the account of the Portsmouth bank and sends the items to it. By this process the Manchester bank has been reimbursed for the items and the Portsmouth bank has paid them. Now the account of the Boston bank with the Manchester bank is credited and the exchange has been completed.

Reciprocal accounts are sometimes settled only at intervals by banks which do not have a heavy indebtedness either way. Once a week or once every two weeks the one bank credits the other with all cash items drawn upon it and paid by the other. At the end of the period agreed upon, the balance is ascertained and the bank which is the debtor on the balance remits to the creditor bank a New York draft or a similar acceptable medium to settle the account. Items which come in thereafter are settled for at the end of the next period.

Clearing Houses as Aids in Transit Collections.—Through the various clearing house associations the banks have increased the efficiency of the exchange machinery. Clearing houses usually arrange to collect transit items on all points in their vicinity. They are able to do this very readily because they collect the amounts from the various members of the clearing house, and each member, being in touch with a considerable number of correspondent banks in its vicinity, agrees to accept and pay for items drawn upon these institutions and reimburses itself merely by a transfer of credit on its books from the debtor bank to itself. The Boston Clearing House, for example, adopted a plan in 1899

under which it agreed to collect checks on all New England points. The Kansas City Clearing House established a collecting system during 1905 which covers a considerable portion of the Middle West. The Atlanta Clearing House established a collection system in 1909. The advantage of all these systems is that they provide a much larger field over which collections can be made without the necessity of asking for direct remittances from the place of payment.

Federal Reserve System as Aid to Transit Collections.—The most notable improvement of the collecting machinery has been made possible by the federal reserve system. Under this system there are twelve districts with a federal reserve bank in each. All the national banks and many of the state banks and trust companies in a district carry permanent accounts with the federal reserve bank of that district. From what has thus far been said it can readily be seen that so far as these banks are concerned the process of collecting transit items becomes one of merely sending checks to the reserve bank of the district, and this bank by bookkeeping entries transfers the amounts called for by the items from the accounts of the banks upon which they are drawn to the accounts of the sending banks.

The territory over which this process can be carried on is further extended by the fact that there is a very close connection between the twelve reserve banks; hence a member bank in any district may send items drawn on member banks and certain others in any other reserve district to the reserve bank of such district. For example, a New York national or member bank would send all items drawn on other member banks within the New York district to the New York Federal Reserve Bank for credit, whereas any items payable in the Chicago district would be sent to the Chicago Federal Reserve Bank; similarly any payable in the Richmond district would be sent to the Richmond Federal Reserve Bank. These banks would be requested to credit

the account of the New York Federal Reserve Bank. This bank in turn, on the basis of the credit which it received in Chicago and Richmond, would credit the account of the New York member bank.

The Gold Settlement Fund.—In the collection of transit items another step remains to be taken. As has just been indicated, the twelve reserve banks carry reciprocal accounts with each other and charge or credit the other reserve banks as occasion requires, but it has not yet been shown how these banks themselves obtain reimbursement; that is, if the reserve bank at Boston owes the reserve bank at Cleveland, how does the Cleveland bank get its money? For this purpose the clearing principle is again invoked. A clearance fund, known as the gold settlement fund, was established in 1915 under the control of the Federal Reserve Board at Washington. This fund is kept in the United States Treasury as a special account of the Federal Reserve Board. Each reserve bank at the time the fund was established was required to deposit $1,000,000 in gold or in gold certificates, and in addition an amount equal to the net indebtedness due to all federal reserve banks at that time. Each reserve bank is now required to keep at all times in this fund a balance of not less than $1,000,000, which balance counts as a part of its lawful reserve.

At the close of business daily each federal reserve bank telegraphs to the Federal Reserve Board the amounts due from it to each of the other reserve banks, and the following day the settling clerks at Washington adjust these debits and credits by book entries. If this settlement results in reducing the amount standing to the credit of any of the reserve banks below the minimum prescribed, the balance is made up by a deposit of additional gold or gold certificates in the Treasury or at any sub-treasury in the United States, or by rediscounting with such other reserve banks as have an excess balance in the fund.

Items Accepted by Reserve Banks for Collection.—The reserve banks will accept for collection in the manner described above only certain kinds of instruments. Each month a detailed list is published by every reserve bank enumerating the items which it will undertake to collect at par. The items must be clean documents, drawn upon member banks of the federal reserve system, or items drawn upon federal reserve banks, or those drawn upon non-member banks which are members of the clearing houses situated in the twelve federal reserve cities, or those drawn upon other banks which will remit at par. The last classification includes those banks which under the privileges conferred upon them by the Federal Reserve Board announcement of June, 1917, have agreed to remit at par for all checks presented to them by the federal reserve banks in return for the privilege of sending their foreign items through the federal reserve banks for collection. No exchange is charged upon the items collected by the reserve banks, but the proceeds of the collection are available for use only after collection has actually been effected.

Time Required for Collecting Transit Items.—In order that the banks may know when the transit items which they have deposited are available as cash, each reserve bank publishes a list showing the length of time required to obtain the funds for credit. This time is based on the number of days required for mail to reach the place of payment plus the time required for the reserve bank to receive remittance in return. All points are classified into divisions according to these periods of time. Thus, there are items available for credit immediately and those available after one, two, four, or eight days. All items except those that are immediately available are entered to the credit of a special account of the sender at par, that is, no exchange charge is made for collection. But this credit is not available as reserve nor for the payment of checks until the period required for collection has expired.

Suppose that a New York bank on a given day sends transit

items amounting to $70,000 to the federal reserve bank, the total being made up of amounts payable as follows: Brooklyn $24,000, Detroit $20,000, New Orleans $16,000, Tulsa $10,000. In handling these items the federal reserve bank credits the collection account of the New York bank for $70,000, but on that day only the $24,000 represented by the Brooklyn checks, which are of immediate availability if delivered before nine o'clock, are credited to the reserve account of the bank. On the second day after the deposit the reserve account would be increased by $20,000, the amount of the Detroit or two-day check; on the fourth day it would be increased by $16,000, the amount of the New Orleans or four-day item; and on the eighth day it would be increased by $10,000, the amount of the Tulsa or eight-day check.

The "Float" and Its Cost.—The cash items which the member banks have deposited but which are not immediately available for reserve or for draft comprise what is called the "float." In the case of a bank which handles a large number of items the amount outstanding in this way runs into very large figures. Before the establishment of the federal reserve system, the banks in New York and other important financial centers usually permitted their correspondents to draw against such items immediately after deposit. The inability to receive immediate credit for transit items is one of the grounds on which some banks have remained outside of the reserve system, for they insist that the loss of interest on these large sums which cannot be used for several days makes membership in the reserve system very expensive. There are, however, advantages in membership which to most students of the subject have seemed to compensate for such loss, but the discussion of this branch of the subject would lead too far afield from the present study of banking practice.

The Operations of the Transit Department.—The work of collecting cash items through the federal reserve banks and

through out-of-town correspondents is supervised within the bank by a transit department. The items which are to be collected are obtained from various departments of the bank, but the receiving teller's department which handles over-the-counter receipts and receipts by mail furnishes the bulk of the items. During the morning each department sorts and sends all its out-of-town items to the transit department. In large banks this department operates in three sections: the night, the morning, and the afternoon sections. The clerks at each rack sort the items received for their group of states according to the banks to which the items are to be sent for collection. In general, these clerks are familiar with the course which checks on any part of the country are to take. For reference, however, in case of uncertainty the bank maintains route books giving a list of the correspondents of the bank and the collection arrangements in effect with each. By the aid of this information the bank employees are able to send the items by the route which will insure the quickest and cheapest collection.

The work of routing requires the most expert knowledge and great alertness. Not only is the transit department responsible for making collections in the quickest and cheapest manner, but it must also see that the collection business of the bank is distributed among its out-of-town correspondents in such a way as to be mutually profitable. In fine, it may be said to be the duty of the transit department to see that the department is operated in such a manner as to pay its way and to engender such cordial relations with other banks as to increase the bank's business.

Routing the Transit Items.—In the attempt to effect collections at minimum cost it often becomes necessary to send items by an indirect rather than by a direct route. For example, a bank may send an item to a correspondent, which in turn has an account with a bank in another place, and so on through half a

dozen banks until one is reached which has a reciprocal account with the institution upon which the item is drawn. Each of these banks may have an agreement with the other to collect items at par or at a small fixed rate of exchange. In such case it is often cheaper for the receiving bank to send the item by this route rather than to send it directly to the paying bank with whom it has no reciprocal agreement whatever.

The past history of banking affords some very striking illustrations of the attempt to avoid heavy exchange charges by a roundabout method of collection. Checks have come back to the bank upon which they were drawn with indorsements, indicating the hands through which they have passed, so numerous that they covered not only the backs of the checks but have even been stamped on the face. An illustration which is frequently quoted is as follows: A check drawn on a bank in Sag Harbor, New York, deposited in Hoboken, New Jersey, was sent from Hoboken to New York, from New York to Boston, Boston to Tonawanda, Tonawanda to Albany, Albany to Port Jefferson, Port Jefferson to Far Rockaway, Far Rockaway to New York again, New York to Riverhead, Riverhead to Brooklyn, and Brooklyn to Sag Harbor. It thus went through nine different banks and over 1,500 miles more than it would have covered had it gone direct. The necessity for this indirect collection has been largely eliminated by the establishment of the federal reserve method of handling transit items.

The Universal Collection System.—When the items have been sorted according to the banks to which they are to be sent, they are indorsed in the usual form by making them payable to any bank or banker and guaranteeing previous indorsements. They are then enclosed with a form letter which gives the name of the sending bank and of the bank upon which drawn, with the amount and instructions as to whether the item is to be protested if unpaid. The work of recording these items has been very much

reduced by the adoption of what is known as the "universal collection system."

This system was put into effect by the American Bankers' Association in 1911. According to the system every bank in the United States has a distinctive number which is given in a directory or key published by the association. It is no longer necessary now to write out the name of any bank since its identity is sufficiently indicated by its number. Each bank's number is usually printed on its checks. Thus checks drawn on the National City Bank bear on their face the numbers 1-8; checks drawn on the First National Bank of Iowa City bear on their face the numbers 72-114. The numbers are allotted in the following manner: The cities which are most important as clearing centers are each given a number ranging from 1 to 49. The states of the Union are each given a number beginning at 50. If the bank in question is located in a city with a distinctive number, it takes that number followed by its own number in the clearing house of such city. Thus New York is number 1, and the National City Bank is number 8 in the clearing house. If the bank is located in a town or city which does not have a distinctive number, it takes first the number of the state and follows this with a special number which has been assigned to it within that state. Thus the First National Bank of Iowa City takes the number of the state, 72, and follows it with its special number within the state, 114.

Settlement for Transit Items Collected.—When the transit items have been received and paid, settlement must be made with the sending bank. This settlement takes any one of three main forms—omitting from consideration the very rare cases in which actual currency might be sent in settlement: First, the settlement may be made by the remittance of local funds. This means, for example, that if the transit items had been sent out by a Boston bank, remittance would be made by its correspondents in drafts on some Boston bank. It should be noted here, however, that

New York funds, or drafts on New York banks, are practically always as acceptable as any local funds because of the fact that New York is by all odds the most important banking exchange center in the country. Secondly, banks which are members of the federal reserve system are always glad to accept credit with the federal reserve bank in settlement of transit items. Thirdly, settlement is often made by means of a bookkeeping entry, according to which the sending bank charges the account of its collecting agent for the amount of the items sent, thereby reducing the deposit liability of the correspondent.

Transit Department as Aid in Analyzing Accounts.—In addition to the characteristic functions of the transit department, certain other duties are performed which are incidental to the main functions. One of these is the preparation of certain reports. One report contains a list of charges which have been made against the accounts of correspondent banks. This report is sent to the general ledger bookkeepers so that they may check up the work of the bookkeepers having charge of the accounts involved. Another report is made to the cashier of the bank showing the changes which have occurred in the bank's reserve account through the operations of the transit department. A third report is prepared and sent to the local federal reserve bank showing all the "direct sendings" to the federal reserve banks and branches throughout the country. This report contains one sheet for each class of items (those sent to one-day, two-day, four-day, and eight-day points), and a recapitulation sheet showing the total of these direct sendings according to the days of availability of the credits. A fourth report, which is furnished to the officers or to the auditors, contains data of importance for analyzing depositors' accounts. The purpose of such analysis is to determine whether and to what extent a given account is profitable for the bank.

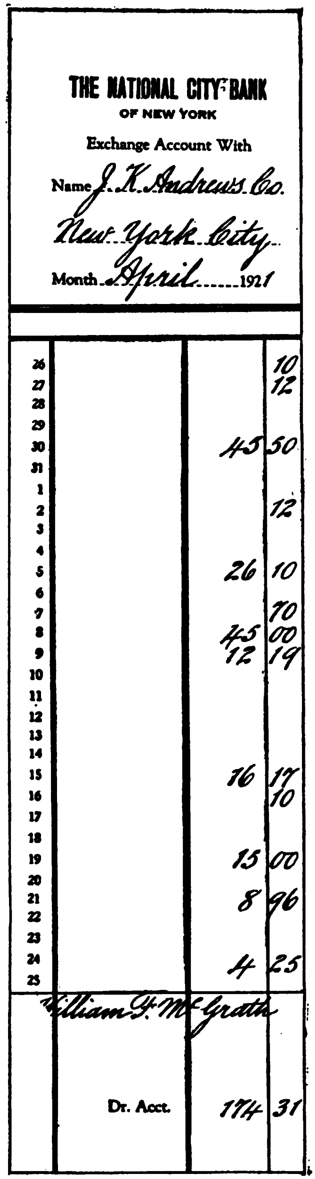
In order to analyze the account intelligently, it is essential

that the bank know the amount and cost of the collection service which it is furnishing gratuitously to the depositor. In the case of some transit items the cost of collection is assessed against the depositor, but in the case of other items the cost of collection is borne by the bank if the account is one which the bank is desirous of retaining. When this free service is rendered, such exchange charges of course represent an expense in carrying the account and therefore must be considered in determining whether or not such an account is profitable. Furthermore, interest is paid on some accounts, but, as was pointed out before, the bank itself does not really obtain the use of the funds represented by the deposit of transit items for as long sometimes as eight days. Obviously, if the bank pays interest to a depositor on funds which it does not obtain for several days, it is losing that amount of interest. This loss is also properly chargeable to the expense of handling such account and must be considered by the cost clerk when analyzing the account.

Assessment of Exchange Charges.—Another duty incidental to the transit work is the assessment and recording of exchange charges. These charges vary somewhat in different sections of the country, but in general they follow pretty closely the schedule prevailing in New York. The rules of the New York Clearing House Association determine the procedure of the member banks in making charges for exchange. Items are divided into two classes: (1) charge items, for which member banks must assess exchange charges or suffer a fine or disciplinary penalty, and (2) discretionary items, for which the bank may or may not charge at its own discretion. A minimum charge of 10 cents is fixed for each item not classed as discretionary, and the charges range from discretionary to 1/4 per cent. They are apparently somewhat arbitrary in nature, but in general the basis for the charge is the time required for collecting the item. In the case of discretionary items the banks usually do not charge exchange

This concession is explained by the pressure of competition.

Collection of Exchange Charges.—It is the duty of the transit department to assess exchange charges on the basis of the rules imposed. Accordingly all items receive the attention of exchange clerks in the transit department before they are sorted into their positions on the racks. All items upon which a charge is to be made are entered upon exchange sheets, of which there is one for each depositor of the bank. These sheets show the date, place where payable, the face of the item, and the amount of exchange assessed. At the end of each month these columns are totaled and a bill covering the charges (Form 12) is presented to the customer. The payments are made according to the desires of the customers, some of them preferring to pay exchange at the time of making the deposit. In such case the receiving teller who accepts the amount of the exchange reports the fact of collection to the transit department. Others prefer to pay their exchange in cash at the end of the month. Such payments are usually received by the note teller. The most numerous class of customers have their exchange bills



THE NATIONAL CITY BANK
OF NEW YORK
Exchange Account With
Name J. K. Andrews Co.
New York City
Month April 1921

26			10
27			12
28			
29			
30		45	50
31			
1			
2			12
3			
4			
5		26	10
6			
7			70
8		45	00
9		12	19
10			
11			
12			
13			
14			
15		16	17
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19		15	00
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25			

William F. McGrath

	Dr. Acct.	174	31

Form 12. Bill for Exchange Charges. (Size 11 x 3½.)

charged to their accounts by the bookkeepers. The bills drawn up by the transit department for exchange in these cases are sent to the bookkeepers, where charges are made against the customers' accounts just as for checks or similar charges.

The Theory of Exchange Charges.—Much confusion of thought prevails on this subject of exchange charges. Many people do not understand how a bank can justly make a charge for cashing their checks when they have sufficient funds in the bank to care for them. The feeling is that the bank has agreed to cash their checks in full on demand and that therefore any charge for exchange is a petty form of graft without justification.

This view is not correct. The ideal system would be to have all checks circulate at par, and it is true that if a depositor presents his check in person to his bank the bank is compelled to give him the amount called for without deduction. But it must be remembered that when a merchant in St. Louis sends his check on a local bank to a creditor in Pittsburgh in settlement of his account, the Pittsburgh man does not thereby receive the money unless some arrangement is made for transferring money or its equivalent from St. Louis to Pittsburgh. He deposits the check in his Pittsburgh bank and receives from that bank the right to draw the cash at will. The Pittsburgh bank recompenses itself in the manner described earlier in this chapter, and ultimately the expense and trouble of transferring actual cash from one place to another must be paid by somebody. In the case just cited the two banks perform a very real service—that of transferring funds from one city to the other. If the drawer undertook to send the money himself he would incur all the expenses and the delays of transportation. Hence it is theoretically justifiable for banks to make what may be called a service charge for this work.

" Exchange " a Service Charge.—To revert to the illustration used, which of the banks actually makes the charge? Some con-

fusion arises as to the origin of this charge because it is assessed against the recipient of the check when he deposits it in his Pittsburgh bank; but the reason for the assessment of the charge in Pittsburgh is that that bank will be compelled to pay when an attempt is made to get its money from the bank in St. Louis. The situation is this: the bank upon which the check is drawn makes a charge for paying the item, which charge is borne by the person who deposits the check. What service does the St. Louis bank perform to justify this charge? It receives money from its depositor in St. Louis and pays money for him to another individual in Pittsburgh. It does this ultimately by drawing a draft on an account which it has built up in some other center.

This account has been built up in one of two ways: either by sending actual cash from St. Louis to the point of deposit, say New York, or by sending for deposit to such account checks, drafts, and other items received in exchange for money which was paid out in St. Louis. So long as the drains upon its account are not particularly heavy, the bank may build up a balance through the deposit of transit items at other points at relatively small expense. But if the demands upon its balance are heavy, it may be forced to withdraw currency from its vaults in St. Louis and pay the shipping and insurance charges in order to replenish the balance. The St. Louis bank is thus put to expense to obtain the means for making it possible to pay the Pittsburgh bank for the check of its local customer.

It is not difficult, therefore, to justify a charge which would compensate the St. Louis bank for such expense. Besides the cost of the shipments of money, every time a bank sends transit items to build up its balance it incurs expense of postage, stationery, and clerk hire; and each time it sends its draft on some central point in settlement of a debit balance against itself which has arisen because one of its depositors has sent his check to another point, it also incurs expense for postage, stationery, and clerk hire. Furthermore, it receives from the customer items

10

which it will not be able to collect for some days, and may give to him the right to draw on those items in the same manner as though cash had been deposited. If it does this the bank suffers a loss of interest on the transaction. The expenses enumerated justify any minimum charge which may be made by the bank.

"Exchange" the Price for a Commodity.—But there is another reason for making a charge for exchange. It is usually conceded that the seller of a commodity is justified in charging whatever price, within reason, his customers are willing to pay. The balance which a bank accumulates in a central money market such as New York, represents a valuable commodity. New York funds are frequently in demand. It is not possible for each merchant or manufacturer in the country to maintain a bank account in New York, and yet there are frequent occasions when such an account would be a great convenience for him. While it is generally impossible for the individual to maintain such an account, most banks, as has been said heretofore, do maintain such an account or have made arrangements whereby they can obtain New York funds. The bank, then, possesses a valuable commodity, funds in New York, which a local merchant wishes to buy. He may get these funds either directly by giving his check or cash to the local bank and receiving in return the bank's draft upon its New York correspondent; or he may get them indirectly by sending his own check to his creditor, that creditor then obtaining New York funds through some New York bank. By this latter process the merchant obtains the funds ultimately through a reduction of the New York balance maintained by his local bank.

At various times the demand for this commodity, money in New York or some other central point, is very great. If the supply of New York funds built up by the local bank is small and if the demand on the part of local customers is great, the bank is justified, regardless of expense incurred in obtaining the funds, in

charging the price for this commodity which is established by the factors of supply and demand in the local market.

Exchange Charges and Cost of Business.—Undoubtedly some banks have taken undue advantage of the opportunity to assess exchange charges and there have been some notorious abuses of the power. Banks which have been established in out-of-the-way places have sometimes obtained a considerable portion of their income from exorbitant charges for paying checks drawn upon themselves. It seems very easy to collect toll in this manner because the charge is levied against a stranger, one with whom the bank never comes into personal contact. The drawer of the check knows nothing of the charge unless his creditor complains that the bank is discounting his checks; and often the distant creditor acquiesces, although with reluctance, because he feels that it is better to get his money immediately rather than to delay settlement by complaining about the charge. He has, however, two lines of defense, either one of which may be used. One is to increase prices to his customer sufficiently to cover the loss due to exchange charges, and the other is to refuse to accept local checks in settlement of accounts, demanding instead remittance in the form of New York draft or postal or express money order, thus putting the cost of transferring funds directly on the remitter.

Federal Reserve System as Clearing House.—While modest charges for the service of transmitting funds may be justified, it is still possible to maintain that even these charges might be greatly reduced if the exchange machinery of the banks were sufficiently well integrated. If, for example, it were possible to conceive of one gigantic bank for the whole nation on whose books every individual and every corporation has an account, all transfers of funds from one person to another, no matter where they might be located, could be effected by means of book entries for which the expense would be practically negligible. While such

an institution would be impracticable in operation, in effect an approach to it has been accomplished in the establishment of the federal reserve system.

As has been pointed out, each of the twelve reserve banks acts as a clearing house for the majority of the transactions within its district; and through the agency of the Federal Reserve Board at Washington and the clearing house there established these twelve banks are brought into close touch. It is not surprising, then, and indeed it was one of the purposes of the Federal Reserve Act, that there is now a system of handling transit items which greatly reduces exchange charges. For a large number of banks throughout the country items are now collected through the federal reserve system without charge. This is, of course, a great advantage both to the drawer of the check and to the drawee. The elimination of heavy exchange charges removes one of the chief impediments in the way of the most effective operation of the mechanism of exchange, and greatly simplifies the work and reduces the worries of the transit department.

CHAPTER IX

COLLECTIONS

Collections versus Transits.—The handling of collection items is an operation that may properly be considered as part of the exchange function inasmuch as most of the collection items have for their purpose the transferring of funds from one place to another and from one person to another in very much the same manner as transit items are transferred. But certain peculiarities characteristic of the treatment and disposition of collection items make it desirable to consider this branch of the subject under a separate head.

As explained in the preceding chapter, there is a paucity of terms to designate certain banking activities, and it becomes necessary here to impose a double burden upon the word "collecting." For example, there is the collecting of cash items and also the collecting of "collection" items. In discussing transit operations collection items are defined as negotiable instruments which are not regarded as the immediate equivalent of cash. They are distinguished from cash items by the fact that they are not settled for by the receiving bank until they are paid, whereas cash items are paid or are credited to the account of the customer when presented, although the bank itself may not receive the funds therefrom for some days. The bank acts merely as agent for the depositor of collection items and assumes no responsibility for their payment.

Duties of a Collection Department.—In its capacity as agent, however, the bank, through its collection department, performs certain other functions not identified strictly with collection activities. It may seek to obtain settlement of past-due accounts

for its customers; it may act as representative for its customers in certain transactions; or it may even be called upon to obtain payment for cash items. Thus, if a bank in a city receives a very large cash item drawn on another local bank, it frequently turns over the item to the collection department to be presented to the drawee bank immediately for payment. The purpose of such procedure is to obtain the funds more quickly than if the item were sent through the regular clearing process, with the idea of avoiding the loss of interest which would be occasioned by the delay.

Characteristics of Collection Items.—The kinds of items which are usually received for collection are checks, notes, drafts, coupons, and matured bonds. Checks are received for collection when there are conditions connected with their history, form, or appearance which make their payment uncertain. For example, postdated or stale checks are usually received on a collection basis, since the receiving bank is uncertain whether the dating may delay or prevent payment by the drawee bank. Similarly checks signed by deceased persons are accepted only for collection inasmuch as the drawee bank cannot pay them except after certain legal processes have been complied with. Checks which require special services, such as wiring advice of payment, are handled also on a collection basis. Finally, a large number of the checks received for collection consist of items which have previously been presented for payment and have been returned dishonored.

It has been said that there are various reasons for the refusal to pay checks, but the fact that payment has once been refused makes the bank unwilling or reluctant to accept such items as cash, and therefore it agrees to act merely in the capacity of agent in seeking to make collection. Sometimes also these dishonored items have been protested and the protest fees are added to the amount of the check. This necessitates the handling of the items by the collection department inasmuch as it is necessary to com-

municate with the maker of the check before paying the additional fees. Checks previously returned unpaid and accepted on a collection basis are presented from time to time according to the instructions of the payee in the hope that they will be provided for.

Collection of Notes.—Notes which have been discounted are usually accepted only for collection because they are merely promises to pay at some time in the future and banks are therefore unwilling to credit customers with the proceeds or to pay cash until they know whether the promise of payment by the signer is going to be fulfilled. Usually notes are held in the collection department until near the time for their payment, when they are forwarded to a correspondent at the place of payment with the request that they be presented to the maker for liquidation. A great many collection items of this sort arise in connection with the purchase of commodities on the instalment basis. Cash registers, mechanical pianos, agricultural machinery, and a large variety of other goods are frequently sold on an instalment plan, under which the buyer gives his notes maturing over a series of months and made payable on his own bank. The collection department of the seller's bank forwards such items to the buyer's bank with the request that it act as collecting agent to obtain payment of the notes.

Collection of Drafts.—A third form of instrument handled by the collection department of a bank is the draft. A draft is an order signed by one person directing a second person to pay to himself, his agent, or other third person a given sum of money. There are sight drafts, calling for payment upon presentation of the draft, and there are time drafts, payable a specified number of days after presentation has been made. Such items can obviously not be included in the cash collections of the bank because the bank has no way of knowing whether payment will be made until the draft has actually been presented to the party upon whom it is

drawn. In the case of the time draft there is the certainty that it will not be paid until the end of at least a specified period. For these reasons such items are accepted not as cash but for collection, and the receiving bank does not advance any funds against them until word has been received of their payment.

Another reason which sometimes arises for handling drafts on a collection basis occurs when the drawer does not wish to pay the exchange charges necessary to have the item collected. He may in such case draw the draft for the amount due him plus exchange. The total amount of the draft is uncertain and the transaction could not, of course, be settled for and handled as a cash item until the amount is definitely known.

Collection of Coupons and Matured Bonds.—Most of the large borrowing corporations in this country which have issued coupon bonds have established paying agencies in one or two large centers, particularly New York. The owners of the bonds are scattered throughout the country. These owners present their coupons as they mature and finally present the bonds themselves for payment at maturity to their local banks. Since the bonds and in a certain sense the coupons are in essence the same as promissory notes, and since also the law requires owners to submit properly executed ownership certificates, there are apt to be uncertainties about the payment of these instruments. The banks, therefore, usually accept them only for collection. They are sent to New York, or wherever the paying office of the corporation may be, and the New York bank, acting as the collecting agent for its out-of-town correspondents, presents the bonds and coupons to the paying office of the corporation. When payment is received, the funds are remitted to the correspondent and by it delivered to the local customer.

Reasons for Handling Collections.—It may seem surprising at first thought that the banks engage in these collecting activi-

ties, inasmuch as this does not seem to be essentially a part of a bank's business. In addition to the fact mentioned in the beginning of this chapter that the collection work supplements and closely parallels the collection of transmit items, there are three main reasons why banks undertake this work. The first of these is service. A bank naturally desires to perform any service that it can for its customers in order to obtain their good-will. Since it is equipped to effect transmission of negotiable instruments and money for itself, the practice has developed of relying upon the bank to transmit and account for collection items for depositors. A second reason is the desire to obtain new business. A high-grade collection service makes a good talking point to attract new customers, and moreover the competition of other banks which furnish this service compels the assumption of the task. The third reason for undertaking the work is profit. While in the case of its own depositors a bank frequently performs the ordinary collection work without making any charge, there are some forms of this agency service for which a fee is collected even from depositors. There are other persons also who desire to avail themselves of a bank's collection services and who are charged a fee commensurate with the service performed. Hence the collection department of a large bank produces in the course of a year a very considerable revenue.

Collection Department Personnel.—The personnel for conducting the collection operations consists, in the case of banks of moderate size, of two or three employees who are spoken of as collection clerks. In banks which transact a relatively small amount of collection business the work may be done by the general ledger bookkeeper, or it may be divided between the general ledger bookkeeper and the receiving teller or some other employee. In the metropolitan banks the work may be so heavy as to require a large staff of employees and several complete departmental organizations.

For example, the work is sometimes divided between a city collection department, which is under the direction of the fifth teller, and the third or note teller's department. The work of the city collection department includes the collection of certain large cash items which the bank wishes to obtain with the least possible delay, and the collection of items drawn on persons in the city which have been received on a collection basis. Such a department also secures the acceptance of time drafts; seeks to collect all cash items which fail of collection through the clearing house or the transit department, or which the bank itself refuses to pay when drawn by its own customers; and finally the collection department is responsible for the rehandling and rerouting of certain items which have been sent to wrong departments or to wrong banks.

In brief, it may be said that the function of a city collection department is to obtain funds for all items payable in the city which cannot be collected through the clearing house or the federal reserve bank. However, as the number of transactions increase further subdivision is necessary, and as a result certain groups of items, although payable in the city, are nevertheless turned over to special employees in the collection department for presentation. Most of this work is handled in the note teller's department or the coupon collection department. In addition to these divisions in the large banks, the work of caring for collection items payable outside the city is performed by a separate group or department called the country collection department.

Messengers' Department.—A further unit of organization sometimes found attached to the collection department is the messengers' department. The function of such a department is to have charge of the presentation and collection of items which are payable in the city. The messengers' department might thus be said to be the arm of the city collection department. More specifically, the messengers not only perform the work of pre-

senting collection items and obtaining payment for them, but carry money, securities, documents, and notices between banks and such institutions as the sub-treasury, the clearing house, the federal reserve bank, and brokerage houses.

Since the demands on the time of the messengers vary considerably at different hours in the day, the members of the department are shifted about from task to task as needed. They may help in sorting the mail or they may serve as special messengers in connection with certain departments. In making collections each messenger travels a certain route, and where the work is large enough to make specialization possible each messenger handles a specific class of items, thus becoming familiar with the procedure of each class. In case of inability to locate the proper person for the presentation of a collection item at his office, the messenger leaves a formal notice as evidence that presentment of the item has been made.

Receiving Items for Collection.—The routine work of the collection department consists in receiving the items which customers send in for collection, and of presenting and obtaining payment for them at the proper time. The items are received either over the counter or by mail, in the same manner as cash deposits. Receipts are given for them, sometimes by entry in the depositor's regular pass-book or, if he presents collection items frequently, by receipt in a special collection receipt book which is provided by the bank. Collection items which come in by mail are, of course, acknowledged in the usual manner.

Presenting Items for Payment.—The second phase of the city collection work is that of obtaining payment of the items. Notes and drafts payable in the city in which the bank is located are first recorded in collection registers. These are record books (Form 13) which show in detail the various items which have been received, and give such information as date, depositor,

DATE	ENDORSER	DRAWEE	LETTER DATE	COLLECTION NUMBER	AMOUNT	PROTEST	INSTRUCTIONS	DISPOSITION
4/27/21	J. Jones & Co Boston, Mass.	East River Produce Co.	4/26	1407	250 00	No	Sight Draft	Paid 4/27/21
"	Norfolk National Bank	John Doe & Son	4/24	1034	3,140 00	Yes	Documents-Acceptance	Accepted 4/27/21
"	do Norfolk, Va.	Watson & Co	"	1035	5,160 00	Yes	Wire Payment	Paid 4/27/21
"	do	Sterns & Co.	"	1036	2,001 40	Yes	B/L Arrival Draft	Paid 5/11/21
"	Merchants National Bank	Bogert & Drew	4/23	3131	2,418 00	Yes	Wire Non-Payment	Paid 4/27/21
"	do Detroit, Mich.	Boyd & Smith	"	3132	137 20	No	—	Paid 4/27/21
"	Riggs National Bank Washington, D.C.	Bank of Montreal	4/26	407A	4,036 10	Yes	Advice Non-Payt	Paid 4/27/21

Form 13. Cc llection Register. (Size 15¾ x 12.)

indorser, due date, place payable, signer or drawee, amount, instructions as to protest, or any other special instructions. Since these items must be presented on the due date, the employees in the collection department determine the exact due date and indicate this on the face of the item. A tickler is also kept which indicates the notes and acceptances which must receive attention day by day. When the items payable in the city are due, they are turned over to the messenger to be presented for payment. If a collection item happens to be a time draft it is presented immediately upon receipt by the messenger for acceptance by the drawee and is then filed away to be presented for payment at maturity.

The Collection of Coupons and Matured Bonds.—Coupons and matured bonds for collection come to the department from several sources. Such instruments may be received from other banks in large quantities, in addition to which the bank holds similar items in safe-keeping for its customers. Many banks perform the service of caring for securities belonging to their customers, and this care includes the collection of coupons and of the matured bonds. Furthermore, bonds are held in large amounts as collateral by the loan department, and at the request of the customer the bank collects the income from such securities for the borrower. Finally, the bank itself may hold considerable blocks of bonds as investments.

The coupons and matured bonds from all these sources are collected, if payable in the city, by messenger in the same manner as other payments are obtained. Coupons, other than those detached from obligations of the United States or any of its subdivisions, must be accompanied by a certificate of ownership on one of the forms prescribed by the Treasury Department. The purpose of these ownership certificates is to enable the paying agent to know whether or not to deduct the income tax which must be paid at the source. One form of certificate is used by

owners claiming exemption from the tax, another form by those who do not claim exemption, and still another form by those who are collecting the income from foreign securities.

The paying corporations usually require that coupons be put up in envelopes (Form 14) of special form prepared by themselves with all details concerning the coupons listed on their face. Sometimes coupons are received which have not yet matured. This error frequently occurs and usually the collection department,

Name Henry S. Brown
Address 905 West End Avenue
City and State New York
Coll. No. — Letter Date Dec. 23 1920
Kind of Coupons Chicago, Rock Island & Pacific R.R.
11 Coupons ea. $ 20 $ 220.00
" " $ $
Due Jan. 1, 1921 Total 220.00

Form 14. Coupon Envelope. (Size 5½ x 3.)

after notifying the owner, is instructed to hold such items for collection at the proper times.

Collecting Out-of-Town Items.—In the work of collecting out-of-town collection items, except for certain differences caused by the dissimilarity in the nature of the documents as already discussed, the procedure is very similar to that followed in the treatment of cash items by the transit department. A record is made of all items in the collection register, and the items themselves are then sent with remittance letters (Form 15) to the bank's correspondents in or near the places of payment with the

request that they be transmitted for collection to the points of payment. Items payable on presentation are sent out immediately, and those payable at some future date are usually forwarded to the bank that is to take the final steps in collecting at least a week or ten days before the maturity of the item. Members of

The National City Bank of New York

Union Trust Co
Chicago. Ill.

April 28. 1921.

For Collection and Advice of Payment. **Do Not Credit Until Paid.**
Please Advise by Number

UNLESS OTHERWISE INSTRUCTED. Do not hold collections for the convenience of parties. Surrender documents attached to drafts only on payment of same. PROTEST and RETURN without delay all dishonored paper. Wire all unpaid or unaccepted items over $500.

We enclose for collection DO NOT PROTEST ITEMS $10.00 OR UNDER.

Our Number	DRAWEE	INSTRUCTIONS	AMOUNT
65829	J. H. Moore & Co.	Documents to be delivered on acceptance	327,40
65830	J. R. Williams & Son	60 Sight Draft for acceptance and return	2,140,35
65831	White & Jones	Wire-Fate	3,104,06

DO NOT PROTEST ITEMS BEARING THE SYMBOL--(N.P.1-8)

Form 15. Remittance Letter for Collection Items. (Size 8 x 7.)

the federal reserve system may make arrangements to use the federal reserve banks for certain collection items.

One important difference between the handling of out-of-town collection items and transit items deserves to be emphasized again. When a bank sends transit items to a correspondent, it immediately charges the account of that correspondent for the amount if settlement between the banks is to be made in this way, as is usually the case, on the assumption that the item will be paid. In sending collection items, however, the account of the

final collecting agent is not debited until advice has been received that the item has been paid. In collecting cash items the bank assumes that payment has been made unless it has specific information to the contrary, while in handling collection items it makes settlement to the owner of the item only on the basis of definite knowledge that collecting agents have succeeded in obtaining the funds.

Unpaid Cash Items.—Another phase of the routine work of the collection department consists in seeking to obtain payment of items that have been returned unpaid. Such items may come from two sources: they may be returned through the clearing house or through correspondent banks when they are drawn upon other banks; or they may be checks drawn upon the bank itself on which payment has been refused for some reason. These unpaid cash items are immediately charged to the customer to whose account they were originally credited. Usually, unless instructed to the contrary, they are protested and the account of the customer is sometimes debited for the fees charged. The items are then transferred to the collection department, and if they are payable in the city the collection department later sends out its messengers to obtain payment. If the payment is made, the amount collected is credited to the account of the original depositor.

If the unpaid cash items are drawn on points outside of the city the collection department, after making the charge to the depositor's account, usually forwards such items on a collection basis. Coupons which are returned unpaid are not protested. The irregularity which prevents immediate payment is usually something which can be adjusted in the course of time and the collection department therefore holds such items and presents them later.

Protests.—Notes, drafts, and similar collection items may be returned unpaid for various reasons and are usually protested

unless the bank is instructed to the contrary, the reason for the protest being indicated. The usual reasons given are: "Inability to locate the drawee or signer," "Account not due," "Amount incorrect," "Check sent," "Goods unsatisfactory," "Unable to pay," "Will pay later," and similar explanations.

Collection of Documentary Drafts.—In handling a collection the bank exercises care to carry out literally the instructions of the owner of the item. A considerable group of items which the collection department is called upon to handle is represented by documentary drafts, concerning which the bank is given instructions as to delivery of the documents. A documentary draft is one accompanied by a bill of lading and other shipping papers. Sometimes it is stipulated by the drawer that the documents are not to be delivered except upon payment of the full amount of the draft; at other times instructions may be to deliver the documents upon the acceptance of the draft. In all cases the collection department is extremely careful to record in its collection register the instructions received in connection with each item, and these instructions must be carried out exactly unless the bank itself assumes responsibility for the payment of the instrument.

Filing and Recording Collections.—In keeping collection items which are not yet payable, a bank endeavors to have them in such form that they will be at hand for presentation on the date of maturity. In the case of sight or matured collection items, either direct presentation is made or, if they are country items, they are mailed immediately to a correspondent bank for presentation. It has been pointed out that ticklers are kept by the collection department to call attention to the notes maturing each day. The items themselves are filed in pouches, wallets, or note boxes. The receptacles are divided into two main sections, one for items payable in the city and the other for items payable

out of town. Each section is subdivided into compartments, each compartment containing the notes of each maturity date. Thus, the notes recorded on each page of the tickler are contained in separate compartments, the country items in one and the city items in another. The items are kept here, as was stated before, until time for presentation.

Payment of Collections.—When payment is made for collection items it may be made in one of five forms:

1. Cash
2. Certified check
3. Cashier's check
4. Bank draft
5. By debit to an account

Payment in cash is not likely to be received by the bank unless the payee is in the same city and even in such cases payment in cash is not frequent. Certified checks, on the other hand, are widely used, some banks requiring that all payments for collection items must be made in this form. When remittance is made by out-of-town collecting agents, they sometimes settle with the primary bank by sending a cashier's check for the proceeds of the collections. This would then be handled by the receiving bank like any transit item.

The fourth method of remittance is illustrated in the use of a bank draft. The out-of-town correspondent may draw on its account with another city bank and send such a draft to the original collecting bank. The instrument would be collected by the receiving bank either through the clearing house or as a transit item, depending upon whether the bank upon which the draft is drawn is located in the same city or not.

The fifth method of obtaining settlement is by the process of debiting the account of the collecting agent or debiting the account of the drawee. For example, a collection item payable in the same city may be settled for, if the drawee is a depositor of

the collecting bank, by charging his account at his request with the amount of the item.

If the collection item is payable out of town, the correspondent who is acting as collecting agent for the city bank advises the bank that payment has been effected, and requests that its account be charged for the amount. In case the collecting agent

THE NATIONAL CITY BANK OF NEW YORK

OFFICE COPY

Date April 27, 1921

Record of credit as follows:

Date of their Letter	THEIR NUMBER	DRAWEE	AMOUNT OF CREDIT
4-26	407A	Bank of Montreal	$ 4,036.10

Credited to:

Riggs National Bank,
Washington, D. C.

CITY COLLECTION DEPT.

Form 16. (a) Letter Advising Credit for Proceeds of a Collection (original). (Size 6 x 8.)

is a city bank with whom the sending bank carries a deposit, the latter is credited for the amount. In this means of settlement Form 16 is used. If the collection has been made through one of the federal reserve banks, it sends an advice stating that collection has been effected and the account of the receiving bank with the reserve bank in its particular district is then credited for the amount; that is, if any items were sent to the Chicago Federal Reserve Bank by a New York bank for collection, the advice of payment would be made by the Chicago bank direct to the New York bank, and the New York Federal Reserve Bank would also

THE NATIONAL CITY BANK OF NEW YORK No.

Date April 27, 1921

CREDIT the account shown in lower left hand corner:

Their Letter Date	THEIR NUMBER	DRAWEE	AMOUNT OF CREDIT
4-28	407A	Bank of Montreal	
			$ 4,036.10

CREDIT

Riggs National Bank,
Washington, D. C.

City Collection Dept.

Checked, WR

W. Smith Clerk

Form 16. (b) Letter Advising Credit for Proceeds of a Collection (duplicate).

THE NATIONAL CITY BANK OF NEW YORK

Dear Sir(s): New York, April 27, 1921

Your account has credit for the following described items:

YOUR LETTER DATE	YOUR NUMBER	DRAWEE	
4-28	407A	Bank of Montreal	
			$ 4,036.10

To
Riggs National Bank,
Washington, D. C.

ALL ITEMS PAYABLE ABOVE 14TH STREET OR OUT OF TOWN ARE CREDITED SUBJECT TO FINAL PAYMENT.

CITY COLLECTION DEPT.

BY Wm Smith

Form 16. (c) Letter Advising Credit for Proceeds of a Collection (triplicate).

advise the bank in question that its account with the New York Federal Reserve Bank had been credited for the amount.

Settlement with the Owner of the Items.—The bank in which a collection item is originally deposited settles with its customer in various ways, depending upon his instructions. Most frequently the customer desires the proceeds to be placed to his credit in the bank. In such case a credit ticket is sent to the bookkeeper in charge of the account and the customer himself is advised that the credit has been made. If the customer desires a remittance, it is made usually in the form of a cashier's check sent by mail. The Cashier's Check account in such case is credited with the amount and when the check is returned the account is debited, thus closing the transaction.

Other Collection Functions.—Besides these more or less characteristic functions of the collection department, there are certain incidental duties performed by the employees in the department. This is particularly true of that part of the work which is handled by the note teller in some of the larger banks. It is said that all the duties which are not strictly allocated to other departments are given to the note teller.

Collecting Overdue Accounts. In addition to the usual collection activities country banks sometimes seek to collect, for out-of-town clients, overdue accounts owing by local persons.

Delivery of Valuable Papers. A bank is frequently called upon to deliver valuable papers such as stock certificates, bonds, deeds, and mortgages to certain parties when these parties have made specified payments to the bank or have performed certain specified acts. Sometimes the bank is requested to sell certain valuables for the customer's account.

Care of Special Deposits. Certain special deposits are handled by the note teller, as has been described in Chapter V in con-

nection with the receiving operations. A closely associated function which is sometimes turned over to the employees in this department is that of issuing certificates of deposit upon the application of the customer and approval of an officer of the bank.

Handling Telegraphic Transfers. The handling of telegraphic transfers of money for customers is cared for by the collection department. The nature of a telegraphic transfer may be illustrated by a typical transaction. A, a customer of the bank in New York, desires to send $10,000 immediately to B in San Francisco. A applies at the window of his bank for a telegraphic transfer, turning over to the bank $10,000. The bank telegraphs its correspondent in San Francisco to pay the amount to B and to charge the item to its account. The San Francisco bank notifies B upon receipt of the telegram and upon proper identification pays him $10,000. The bank in New York credits the account of the San Francisco bank on its ledger with $10,000, and the San Francisco bank in turn makes a debit entry against the reciprocal account of the New York bank.

Issuance of Cashier's Checks and Bank Drafts. Another miscellaneous activity of the collection department consists of the issuance of cashier's checks. A cashier's check is a check drawn by the cashier of a bank against a special cashier's account in his own institution. Such checks are used frequently by banks in making payments to those to whom they are indebted, and are sometimes used instead of certified checks and bank drafts in making transfers of funds from place to place. Where the volume of work in issuing cashier's checks is considerable, the employees in the collection department or note teller's department, or in some cases the general ledger department, draw up these checks, sometimes having them signed by the cashier and sometimes by another properly authorized person.

The issuance of bank drafts in many banks is handled by the paying teller; in others it is handled by a special draft clerk or by employees who are engaged in the collection work.

Care of Certain Remittances. It sometimes happens that a bank receives remittances which are not accompanied by instructions sufficiently clear to enable it to dispose of the funds. Such remittances are sent by the various receiving departments to the note teller's department to be held until proper disposition can be made of them.

It is thus evident that a great many duties not strictly pertaining to collection work are performed by those who are charged with the collection work of the bank. This diversity of functions is explained by the fact that the collection work in itself requires the bank to exercise agency activities, and having once embarked on agency activities the bank is likely to be called upon to perform many other related services.

The Bank's Revenue from Collection Work.—While a good many of the services performed by the collection department of a bank are offered as services to the customer, and therefore without charge, many other transactions are made to pay for themselves by the imposition of a moderate charge. Some banks establish a minimum fee for collecting items, and this minimum charge is supplemented by a charge of $\frac{1}{10}$ per cent in the case of large items. The associated banks in New York usually perform their collection operations within the city without any charge to the depositor, but for items payable in places other than New York the clearing house rules require the collection of exchange at minimum rates designated by the clearing house. For some of the incidental activities, such as the delivery of valuable papers on the completion of a contract or the selling of certain property, banks sometimes charge an arbitrary fee, but more frequently they perform such service gratuitously for their customers. It may be said in general that in most cases banks do not count on making the collection department yield any considerable direct revenue. Such a department is profitable to the bank indirectly because of the fact

that it obtains the business and the good-will of those who make use of its services.

Distribution of the Collection Department Receipts.—The receipts of the various collection departments are disposed of in the same manner as are the receipts of the other operating departments which have already been described. The cash goes to the paying teller, debit and credit items for individual accounts are sent to the bookkeepers handling such accounts, the debits and credits to the various bank correspondents' accounts are sent to the bookkeepers in charge of those ledgers, and the items to go to the clearing house are sent to the clearing desk. Credits for exchange collected are delivered to the general ledger bookkeeper for record among the profits of the bank. Where the collection department is divided, as previously explained in this chapter, into a fifth teller's department and a third teller's department, each of these tellers prepares a proof of his day's work. These proofs record the cash and cash items received and those sent out. When the desks are cleared the total cash receipts and the total cash items distributed to other departments of the bank should be equal.

Significance of the Department Proof.—The fifth teller's proof has special significance because, in addition to serving as a condensed journal record of the transactions passing through the department for the day, it constitutes an inventory of unfinished cash work, since all unfinished items are charged to this department at the close of the day. In this function it somewhat resembles the paying teller's proof, which furnishes an inventory of the amount of cash on hand.

CHAPTER X

THE FOREIGN EXCHANGE BUSINESS

International or World Exchange.—The fourth class of exchange transactions, as listed in Chapter VII, are those which involve the settlement of balances in different parts of the world. These transactions are usually referred to as foreign exchange, to distinguish them from the other three classes of exchange transactions facilitated by banks, which are known as domestic exchange.

Within the limits of a single country, it will be recalled, funds are transferred from one person to another in either a near or a distant place by simple transfers of credit on the books of banks, and the banks settle between themselves for these transfers, one bank requesting another to debit its account while it credits the account of the particular correspondent involved or vice versa. In foreign exchange transactions a similar interrelation exists between the banks in one country and those in other countries, making it possible for them to settle the accounts of individuals in the different countries by obtaining debits or credits, as the case may be, on the books of foreign banks which are correspondents. Thus, if a New York bank and a London bank each maintain an account with the other, it is a simple matter for an American importer who desires to pay his bill in London to go to the New York bank, and, by depositing a sufficient amount of money, to receive from the New York bank an order addressed to the London bank requesting it to pay a specified sum to the London seller of the goods. When the London shipper receives this order or draft and presents it to the London bank, he receives the money or credit to his account, and the London bank reduces the balance maintained with it by the New York bank to the extent of the order.

Foreign versus Domestic Exchange.—While the transaction is fundamentally the same as that found in the domestic relations of a bank and its customers, there are two important differences. One of these is that the money terms in which the transaction is negotiated and settled differ for different countries. Thus, the English merchant measures values in terms of pounds sterling, whereas the American thinks of money in terms of dollars. Hence when a local customer takes his money to the New York bank and exchanges it for an order on its London bank account, he must bear in mind the fact that the Englishman keeps his accounts in another monetary unit, and therefore provision must be made for converting American money into English money.

The second important difference between the domestic and foreign settlement of obligations between individuals grows out of the fact that the credit of the individual is not established widely enough to permit him to settle his accounts in foreign countries by means of his personal check on a local bank. In the case of domestic transactions the merchant in one part of the country may pay his bill in another part merely by drawing his check on a local bank, leaving the settlement and transfer of funds to be made between the banks; but in international transactions this is impossible. An importer in Chicago cannot settle his indebtedness to an English exporter by sending his personal check drawn on a Chicago bank. The banks must be called upon to facilitate this exchange transaction to a greater extent than in domestic exchanges. The American importer, instead of drawing his check on a local bank, obtains from his bank its own check or draft, or the draft of one of its correspondents, on the balance maintained by the bank making the draft in the country to which remittance is to be made.

"Foreign Exchange"—Two Meanings of the Term.—The foreign exchange business consists of the supplying of facilities, by banks and commercial houses with international connections,

by means of which their balances with each other may be used for the purpose of settling the indebtedness of individuals in different countries. No attempt will be made in this book to discuss the theory of foreign exchange exhaustively, as there are special works on foreign exchange which thoroughly cover the field. The purpose here is merely to show the manner in which transactions in foreign exchange enter into the banking business.

The term "foreign exchange" is sometimes used in a qualifying or adjective sense to describe the nature of the business, as in speaking of the foreign exchange business, or of a foreign exchange department, or a foreign exchange dealer. Again, it may be used as a noun to indicate the material entering into international banking transactions, as for example, when referring to the supply of foreign exchange or exchange on London, that is, the balances available for use in effecting the international settlement of obligations. In this connection foreign exchange is regarded as a commodity which is bought and sold, like cotton, grain, or other staples. The stock of the foreign exchange dealer consists of his balances available in other countries which he can use for the benefit of his local customers in settling their international obligations.

The Mechanics of Foreign Exchange.—From the above description the nature of the foreign exchange service rendered by banks to their customers can be readily understood. It is the furnishing of facilities for making transfers of funds from one country to another. In brief, these transfers are made possible by the fact that the bank furnishing the service has established a credit balance with other banks in the leading financial and commercial centers of the world, and that for a satisfactory payment it accepts the deposit of funds from the local buyer and transmits these funds to the foreign seller by delivering to its local customer a draft on its account with the foreign bank drawn in terms of the money units used in the foreign country. This draft is then

mailed by the buyer to the seller, and when it is presented by the latter to the bank upon which it is drawn the money is paid out and charged to the account of the issuing bank.

Antiquity of the Foreign Exchange Business.—The business of facilitating international payments by means of bills of exchange is one of the oldest of banking functions. Bankers, merchants, and money-changers in the medieval trade centers of Europe carried on a very extensive business in the handling of bills of exchange. In many cases they actually exchanged the coins of the various countries, handing to each customer the kinds of money material he desired; and money itself was transported from one country to another for the settlement of accounts more frequently in proportion to the amount of business done than is the case today. The more intimate banking and trade connections which have been developed with the passage of time and the phenomenal improvements in means of communication have reduced to a minimum the actual shipments of money for the transaction of foreign business.

Mint Parity between Gold Standard Countries.—The alternative to the shipment of money consists in obtaining from a banker who maintains a balance in a foreign country the privilege of using part of this balance in the settlement of an obligation. To obtain this privilege requires the deposit of an equivalent amount of money with the bank which is granting the privilege of using its account. Since the money units of different countries vary, it becomes necessary to ascertain how much money of a given kind—say, dollars—it will require to obtain a similar quantity of some other money, for instance, pounds sterling. The calculation is made by ascertaining the quantity of gold or other standard money material in the monetary units of each country, and then dividing one by the other to see how much of one it takes to equal the other. For example, the standard mone-

tary unit in the United States is the gold dollar, containing 23.22 grains of pure gold. The pound sterling or gold sovereign, which is the English unit, contains 113.002 grains of pure gold. Dividing the gold content of the pound sterling by the gold content of the dollar, it is found that it takes $4.8665 in American money to provide a quantity of gold equal to that found in the pound sterling. This figure ($4.8665) is called the "unit par" of exchange between the two countries.

Other Elements in the Rate of Exchange.—Such a calculation, however, does not in itself determine the amount which the banker will demand to transmit a given quantity of American money to England. In building up the balance against which he draws, the banker has incurred certain expenses. He may have shipped actual gold to the English correspondent to obtain a balance. In such an event he would incur the expenses of transporting the gold and he would seek to recover his outlay from those who use the balance. Furthermore, he is dealing in a commodity, exchange, which is in demand and which therefore fluctuates in price according to the volume of the supply and the extent of the demand of buyers. If there are a large number of persons desiring to use the balance he has built up, the banker may be able to exact a price which will give him a considerable profit on the transaction. If, on the other hand, there are a large number of bankers who possess similar balances which they wish to sell and the number of buyers of exchange is relatively small, competition among the sellers may bring down the price to a point where the sellers may suffer loss in disposing of their balances.

Limitations on the Price of Exchange.—Under normal conditions, with gold readily obtainable and no difficulties in the way of transporting it, it is usually assumed that the price asked by a banker for a draft on his account cannot exceed the mint par by

more than the cost of shipping gold. Otherwise the debtor has the obvious alternative of obtaining gold bullion and shipping a sufficient quantity of it to equal his indebtedness in the foreign currency. On the other hand, under the assumed conditions, the price to which exchange might fall below the mint par is determined similarly by the cost of importing gold. If the banker could not get anybody to pay him for a draft on his account as much as he would obtain by having gold shipped and paying the expenses for transportation, he would suffer the least loss by importing the gold himself.

Gold Export Point and Gold Import Point.—The points above and below the mint par at which it is profitable to export or import gold rather than to buy or sell bills of exchange are spoken of as the gold export and the gold import points. The general statement is that if the price charged for a bill of exchange exceeds the cost of shipping gold in settlement of the account, gold will flow out of the country. The point at which it becomes profitable to ship gold is the export point. Conversely, the point at which it becomes profitable to import gold rather than to sell bills of exchange below the mint par becomes the gold import point. As indicated before, these points are said to be above and below the mint par by an amount equal to the cost of shipping gold. The price-making process for exchange might be briefly covered in the statement that within the upper limit established by the cost of exporting gold and the lower limit established by the cost of importing gold, the price or rate of exchange fluctuates according to supply and demand.

The cost of shipping gold, however, is not the sole determinant in establishing the upper and lower limits in question. Gold may be impossible to obtain, or even if obtainable there may be restrictions upon its export or difficulties in the way of its transportation. These conditions may make it necessary to pay a very much higher price for exchange or to sell exchange for a very

much lower price than would normally be expected. Furthermore, the gold shipping points vary with the cost of shipment.

Since 1914 all these influences have had a part in causing extreme variations in the price of exchange on different countries. Gold has been difficult to obtain; there have been embargoes on its exportation and in some cases on its importation. Transportation has often been dangerous and frequently impossible to arrange for, and when arranged for the cost has frequently been extremely high. Hence, even though rates of exchange frequently reached points where it would have seemed desirable to ship gold, gold was not shipped, either because it was not obtainable or because it could not be transported except at great risk and cost. Added to these difficulties was that occasioned by the complete readjustment in trade relations brought about by the war, which made some countries heavy debtors to others. These adverse balances became so large that there was not sufficient gold to pay them, even if the whole stock in the possession of the country in question had been shipped. Hence there was extraordinary competition to obtain from those banks which had balances in the locality where settlement was to be made the right to use those balances. This competition resulted in establishing the rates of exchange at levels previously unheard of.

Commercial or Market Parity.—The exchange situation brought about by the war strikingly illustrates the fact that exchange dealers and merchants are interested in the mint par of exchange only incidentally. What interests them chiefly is the commercial parity. Commercial parity may be defined as the rate at which bills of exchange drawn on a foreign point can be bought from or sold to dealers, or in the market. These rates fluctuate from day to day according to demand and supply rather than according to the intrinsic worth of the various moneys involved. These variations would occur even if the money units of the several countries involved were identical. For example,

the rates for exchange on New York prevailing in Canada, where the money units correspond to those in this country, fluctuate with the demand. When the trade balances are running heavily against Canada and in favor of the United States many Canadian merchants apply to their local banks for drafts on New York. If the Canadian banks have small balances in New York, and if a great many of their customers wish to use these balances, they will charge a higher price for drafts than they will if their balances are large. In the latter case they may be eager to exchange the balance in New York for cash received from the local debtor.

Similarly, if the merchants of any country, say Great Britain, export more than they import, there will be a great demand on the part of the foreign buyers of English goods for exchange on London—assuming, of course, that there are no other equalizing tendencies. As the balances of the foreign banks in London decline under this heavy demand, competition for the purchase of the remaining balances will cause the rate of exchange on London to rise and the rate of exchange on the other country in the transaction to decline. The discussion of exchange rates, accordingly, requires an analysis of the causes which affect the supply of, and the demand for, bills of exchange.

Bills of Exchange, Commercial Bills, and Bankers' Bills.—A familiarity with the meanings of the terms used is necessary before one attempts to discuss the operations of buying and selling exchange. The term "exchange" itself is used to designate the balance, either present or in prospect, standing to the credit of the seller of the exchange and against which he makes the sale. The order which the seller of exchange draws against this balance and which corresponds to the check—or more nearly the bank draft—in domestic exchange, is spoken of as a draft or a bill of exchange. These documents are of various forms but they are spoken of generically as bills. They may be divided into two main classes, commercial bills and bankers' bills. The former are

drafts which are drawn by commercial houses, that is, houses other than banks. They are usually drawn in settlement of obligations growing out of commercial transactions, such as the exportation or importation of commodities. Bankers' bills, on the other hand, consist of drafts drawn by banks on other banks.

Clean Bills and Documentary Bills.—Commercial bills may be classed as clean bills or documentary bills. Just as in the case of domestic exchange drafts drawn for the purpose of collecting funds from the buyer of merchandise are frequently accompanied by bills of lading and other shipping documents which are to be delivered only upon payment of the draft; so in international trade many drafts are drawn in connection with the shipment of goods which have shipping documents attached, and which carry instructions that these documents, giving possession of the goods, are to be delivered only on payment of the draft. Drafts thus accompanied by shipping papers or other documents are spoken of as documentary bills, while those which are not thus accompanied by documents are spoken of as clean bills. Clean bills are used to effect a settlement after the goods have been delivered or for payment of standing accounts.

The Ocean Bill of Lading.—The most important document which accompanies a foreign draft is the ocean bill of lading; like the domestic bill of lading, it is both a receipt for goods delivered to a transportation company by the shipper and a contract between the transportation company and the shipper covering the conditions under which the shipment is to be made. An ocean bill of lading is drawn up in several copies, according to circumstances. Some of the copies are negotiable and others are not. Those which are negotiable represent title to the goods and are issued for the purpose of transferring commodities from one party to another. Those which are not negotiable are issued for pur-

poses of record. The collecting bank is concerned only with negotiable copies.

Ocean bills of lading are drawn either to order or directly to the consignee. An order bill of lading may be drawn to the order of the shipper or in blank. It is indorsed by the shipper to his bank, by the bank to its foreign correspondent, and by the foreign correspondent to the consignee of the goods. On its margin is usually stamped a clause requesting the transportation company to notify the consignee when the goods arrive at their destination.

Marine Insurance Policy.—Another important document which usually accompanies the commercial bill is the marine insurance policy. Foreign shipments are almost without exception protected by insurance against losses which may occur in transit. In contrast with the domestic railroad company, which is by law virtually the insurer of the goods it carries, the ocean carrier is legally liable for only a few of the risks of transportation. Hence the insurance policy becomes a necessary means of protecting the owner against shipping risks.

Invoices and Certificates.—There are various other documents which sometimes accompany the drafts. The invoice is used in the same sense in foreign trade as it is in domestic transactions. It provides an enumeration of the goods contained in the shipment, together with the selling price and a statement of whatever charges, such as freight, insurance, and similar items, are included in the seller's total bill against the purchaser. Such charges are sometimes borne by the seller and sometimes by the buyer, according to the terms of the sale. Usually the purchaser pays those expenses which occur in connection with the shipment after it has been loaded on the ship by the exporter. In the case of certain commodities, certificates of weight, analysis, and inspection are required by the customs authorities.

Another document is the consular invoice. This is a document

certified to by a consul of the country to which the shipment is consigned, giving a description of the goods and a declaration of their value, for the assistance of the customs authorities. Certificates of origin, certifying that the merchandise is a production of the country from which it is exported, sometimes accompany the draft.

Payment Bills and Acceptance Bills.—Documentary bills are further classified as payment bills and acceptance bills. Payment bills are those which specify that documents are to be delivered only upon the payment of the amount of the draft. Acceptance bills are those on which the documents are to be delivered when the drawee accepts the draft. As the possession of the documents gives possession of the goods, acceptance bills from their nature involve more risk than payment bills. In the case of the latter possession of either the money or the goods is always retained by the shipper or his agent, whereas in the case of acceptance bills the goods are given up on the mere promise of the acceptor that he will pay. The credit rating of the bill varies of course with the acceptor. If accepted by a large well-known bank, an acceptance bill has very high credit rating.

Short Bills and Long Bills.—A further classification may be made on the basis of the time for which the bills are to run. There are bills known as short bills and others known as long bills. Short bills run usually for 10, 15, or 30 days from sight or date, while long bills run for 60, 90, 120 days, or even six months. Sometimes these time bills are drawn payable a certain number of days "after date"; at other times they are drawn "after sight," that is, after presentation. This distinction is of importance. In a foreign transaction several weeks may elapse between the making of the draft and its presentation. A foreign draft drawn "90 days after date" might be payable much sooner than one drawn payable "90 days after sight."

Commercial Checks.—Commercial checks are sometimes encountered in foreign exchange. A commercial check is a check drawn by a commercial house on its balance in some other country. Some of the large trading and manufacturing concerns maintain deposit balances in foreign banks; and in order to transfer funds from such accounts to their home office, they draw checks on this balance and sell them in the foreign exchange market.

Bankers' Checks.—The most common type of foreign exchange instrument issued by bankers is the bankers' check. This instrument is similar to a commercial check in all respects, except that it is drawn by a banker against balances standing to his credit in foreign banks. American bankers' checks are used frequently by Americans who wish to make remittances abroad. Bankers' checks drawn by American banks may be either in dollars or in foreign currency, depending upon the contract between the remitter and the payee. Foreign currency drafts are the more frequently used, although the use of dollar drafts is increasing. If the drafts are drawn on foreign currency, the payee in the foreign country obtains payment of the face amount of the draft in his own money. On such a draft the remitter bears the expense. Any uncertainty, moreover, as to rate of exchange is his affair.

A bankers' check drawn in dollars and payable in a foreign country necessitates, on the part of the payee, the conversion of the dollars into the money of his own country. Usually, of course, the payee prefers to have a check come to him in such units that he can use the funds immediately with no risk as to the rate of exchange. If, however, dollars are appreciating in value compared with the foreign currency, the request is frequently made for a remittance in dollar exchange, in the expectation that by the time the draft reaches the payee dollars will have further appreciated. If the expectation is realized, the dollar can then be converted in the exchange market into a larger amount of the

foreign currency than would have been obtained if the conversion had been made at the time the draft was forwarded by the American debtor.

Bankers' Long Bills.—Bankers' short-time bills are not very often encountered, but bankers' long bills are used by importers who have debts maturing abroad at some time in the future for which they wish to provide funds. Long bills can usually be purchased at a lower price than sight or cable exchange because the banker selling the long bill has the use of the money during the period the bill has to run. The difference in price, therefore, tends to vary with the rate of interest prevailing at the time the bill of exchange is sold. It is modified, however, by anticipated changes in the rates of exchange between the date of the sale of the bill and the date of its maturity.

The use of the bankers' long bill may be made clear by illustration. A in America owes B in England £1,000 payable in 90 days from date. A has the money at hand to pay immediately, but there is no advantage in paying B in advance nor does A want to have his money idle. He finds that the rate for a bankers' check today is $3.76, while for a 90-day bill it is $3.70. In the one case it would cost him $3,760 and in the other $3,700 to buy the exchange with which to pay B. The long bill would obviously be cheaper by $60. He therefore invests his $3,700 in a bankers' long bill of £1,000 due in 90 days and sends this to his English creditor. The latter may hold it until maturity or he may have it discounted in the London money market.

Long bills are also used by bankers in their foreign loans and financial operations. Thus, if the rate of interest for money in the New York market is higher than the rate prevailing in the London money market, an American banker might draw a long bill for a certain sum, at the request of his London agent or correspondent, and sell it in the New York market, lending the proceeds at the prevailing rate. Such loans may be secured by collateral.

The buyer of the bill forwards it to London, where it is accepted and discounted at the lower rate prevailing in the London market. When the loan in the New York market is paid off at maturity, the proceeds are used to buy a sight draft on London; and this document is mailed to the correspondent bank in time for it to obtain the cash with which to pay the long bill which it has previously accepted.

Financial Bills.—A type of bankers' long bill which is different in nature, though exactly the same in appearance, is the finance bill. This instrument is an example of pure credit in lending operations, no collateral being deposited. The distinction between this type of bill and the one previously described is that in the former case the drawing bank acts as lending agent for the drawee bank, while in the latter the drawing bank virtually borrows for itself in its own money market on the strength of the acceptance of the drawee bank. The drawee bank is not required to pay any money until the bill matures, say in 90 days, and before that time the drawer forwards by cable or sight draft the funds with which to meet the maturing long draft.

Sight Drafts: Cables.—As contrasted with the time bills, there are two other forms of draft. One of these is the sight draft and the other is the cable. The sight draft is an instrument which is payable on presentation. Bankers' checks are of this class, as are also commercial sight drafts. A cable transfer is one in which the details and orders are sent by cable instead of by mail. The distinction between a cable and a sight draft is that the cable requires only a few hours for its transmission, whereas the sight draft goes by mail and therefore may require the elapse of days or weeks before payment can be expected. For those transactions which necessitate the transfer of money immediately, the cable is used. Cable transfers correspond essentially to transfers by telegraph within the country.

CHAPTER XI

METHODS OF HANDLING FOREIGN EXCHANGE

Dealers in Foreign Exchange.—The purchase and sale of the various kinds of bills arising in connection with foreign exchange require an expert knowledge, not only of the nature of the transactions, but of the underlying economic forces which are likely to affect the rates of exchange. Hence the actual dealings in exchange are made by specialists. The foreign exchange dealers buy and sell exchange both at wholesale and retail. They are the intermediaries between those who have exchange to sell and those who wish to buy it. The manner in which exchange is accumulated and the kinds of transactions which cause the demand for exchange will be discussed in the succeeding chapters; but in anticipation of that discussion it may be said that those who sell goods or services to other countries are likely to have bills of exchange on those countries for sale, and those who import goods or services from other countries are likely to wish to buy exchange on such countries. It is the business of the traders in foreign exchange to buy from the one group and sell to the other. A profit from such transactions is obtained by the purchase of exchange at low prices and the sale of that exchange at higher prices.

New York the Foreign Exchange Center of the Country.—The buying and selling of foreign exchange, so far as the United States is concerned, is confined largely to New York and to a relatively small number of banks in that city. While transactions in foreign exchange originate in all parts of the country, they are mostly effected through the traders in New York. Accordingly, most bankers throughout the country act only as agents for the

purchase and sale of drafts, sending their orders for execution to their New York correspondent.

Functions of the "Traders."—Banks handling foreign exchange have a special department or division devoted to the business. The actual trading is in the hands of the group of experts known as the "traders." These traders have two main functions: to determine the rates of exchange which the bank will use in its dealings with its correspondent banks, and to buy and sell foreign exchange in the open market. Transactions in foreign exchange come to the traders from other divisions of the foreign department and also from other dealers and large users of foreign exchange.

The purchases and sales of foreign exchange by a bank in its relations with its customers are very numerous and involve large amounts. The traders are kept informed as to the amount of exchange arising in connection with the operations of the various departments of the bank, such as the foreign discount and foreign collection operations, and are informed also of the demands which have been made upon the stock of exchange through the selling operations of the bank, such as the sales of bankers' drafts made by interior correspondent banks, who rely upon the metropolitan institution to supply them with the exchange which they sell to their local customers.

The Foreign Exchange Market.—In addition to the great volume of transactions in foreign exchange which arise within the bank in the conduct of its regular business, the traders participate in transactions in the open market. This market is composed not only of the dozen or more large banks and other dealers in foreign exchange in New York, but includes also any other banks doing a foreign exchange business in the other large cities in the United States and in all parts of the world. Large international business houses owning deposits in various centers abroad also constitute

a part of the market. These transactions are nearly always of the type which might be regarded as wholesale operations.

In addition to the traders in the foreign exchange department of a large bank, there are bookkeepers and clerks who record the rates of exchange prevailing in other financial centers and keep a record of the balances which the bank accumulates in these centers. The traders themselves perform the actual operations of buying and selling exchange and quoting rates.

Exchange Rates in Other Markets.—The first move in the day's business is to ascertain the rates which prevail in the other leading exchange markets. Because of the ease of communication, the foreign exchange market is world-wide. Hence the rate at which exchange can be bought or sold in New York depends largely upon the rates prevailing in such centers as London, Paris, and Berlin. Although London has for years enjoyed preëminence as the leading financial center of the world, actual trading in exchange has been of minor importance; for most of the world's bills have been drawn on London and have been bought and sold in other markets. The function of the London money market has been to discount these bills which are drawn in terms of sterling. However, with the growth in popularity of dollar exchange, dealings in exchange have increased in London.

Because of differences in time, the business day in Europe commences about five hours before the American business day, and trading has therefore been in full swing for some hours before the market in New York opens. The foreign exchange dealers in New York, as a result, are in the fortunate position of being able to see a large part of the world market in operation before they actually do any trading. The information as to quotations and market conditions is received by cable from correspondents and dealers.

The Parity Sheet.—For the convenience of the traders in handling transactions, a parity sheet is prepared. This sheet

consists of a tabulation of the rates quoted in the chief foreign exchange markets of the world, expressed in terms of the American market. Space is provided for entering the quotations of England, France, Belgium, Italy, Holland, and Germany in detail, while those of other markets are shown in more condensed form. Thus, for the chief foreign exchange centers, the parity sheet shows the cable rate, the demand rate, and the rate for 30-, 60-, and 90-day commercial drafts, as well as the discount rates for commercial paper prevailing in such markets. In the case of sterling exchange there are also shown the factors which are used to determine the rates respectively for 60- and 90-day bills, interest being computed at the rates prevailing in the various foreign markets. Foreign rates are also received by cable at different times during the day. As these changes in the rates are received, entries are made on the parity sheet. Thus at any time during the day the parity sheet furnishes a composite picture of the foreign exchange markets of the world, and gives also some indication of the tendencies in the market.

The Cable Rate.—The cable rate, which is, as has been explained, the price of a cable transfer, expresses most nearly the exact market relation between the two countries. It is the highest rate on the sheet, because a bank selling such a transfer does not have the use of the funds involved for any appreciable length of time. The bank's account abroad is charged with the amount of the transfer within a few hours after it receives the selling price from the customer. Viewed from another angle, the higher rate for a cable transfer represents the premium which the purchaser must pay for the privilege of retaining the use of his funds up to the moment that his payments fall due abroad. If instead of purchasing a cable he has bought a sight draft in order to make his remittance, he would have to mail the draft at least ten days or two weeks earlier, and he would not have the use of his money during the time it is in transit. Another reason for

waiting until the last minute and then remitting by cable is that the sender may thus take advantage of any intervening fluctuations in the rates of exchange.

Making the Rates; Sounding the Home Market.—After they have studied the trend of the exchange markets abroad as shown on the parity sheet, the traders sound the local market for the latest developments before they decide upon a policy for the day. They rely upon interviews with the brokers who come in during the early part of the morning of each day with offers to buy and sell, and also upon telephone information as to the rates quoted by other traders in the market.

Buying and Selling Rate.—After having formed their opinion upon the market, the dealers quote the rates at which they will trade in exchange. Two rates are quoted—the buying rate, the price which the bank offers to pay for exchange, and the selling rate, the price at which it will sell. These rates are given publicity either in response to telephone calls, or by making bids and offers to brokers, or by word of mouth. They are further disseminated to out-of-town banks and exporters by telegraph, and foreign customers of the various banks and traders receive quotations by cable. Rates quoted to the groups of customers specified are what are known as "firm rates," that is, they are actual offers to buy or sell exchange at the rates quoted. Besides these rates, many rates are sent out merely to give information regarding the state of the market.

Informal Contracts to Buy or Sell.—After these quotations have been widely distributed among the bank's customers, the orders for the purchase or sale of exchange begin to come in from out-of-town dealers as well as from local customers. On the basis of the bids and offers the traders make their contracts. The contract or agreement, however, usually takes no more formal shape

than that of telegrams or cables passing between the two parties, one message constituting the offer and the other the acceptance. Agreements are often made orally, to be confirmed immediately afterwards in writing. Because of this absolute reliance on the integrity of the various dealers, contracts are entered into only with such parties as have had previous dealings with the bank or who have come properly introduced.

Recording the Formal Contract.—When a contract has been completed the details are entered upon a contract slip which is initialed by the trader who made the transaction, and entry is then made in a purchase and sale book. This book has a section for each foreign currency; contracts for the purchase of exchange are entered on the left-hand page and contracts for the sale of exchange on the right-hand page. Such a record furnishes a ready reference at any time during the day for the purpose of determining the volume of business transacted and, in connection with the "position sheet," it enables the bank to ascertain the state of its foreign balances. Each entry shows the name of the contracting party, the kind of contract, the amount, and the rate, and carries an identifying number stamped on the contract slip.

Spot and Future Contracts.—The contracts are either "spot" or "future." A future contract differs from a spot contract only in that delivery and payment for the sum involved is to take place at a stated future time. The purchase and sale of future contracts in foreign exchange is one of the most useful phases of the bank's work in facilitating international trade and finance. An example will show the advantage of these facilities to an importer. Assume that a clothing manufacturer imports £10,000 worth of wool every month from Australia. To enable him to carry on his business on a fixed basis for the ensuing year, that is, to compute the costs, selling price, and profits in advance, he must know what the sterling exchange with which he is to pay

for his raw material will cost him. Accordingly he contracts with the bank to buy the necessary amount of sterling each month for twelve months. If the state of the market is such that the exchange dealers expect higher rates in the future, they will quote him a certain rate for his January instalment, a slightly higher rate for February, and so on during the year. In any case he is able to know in advance what each monthly shipment for the ensuing year will cost him.

Cover for Future Contracts.—The bank, however, does not wish to assume the risk of fluctuations in the rate of exchange, and therefore it immediately protects itself by purchasing a similar amount of exchange to be delivered at the stated future intervals. Unless the bank can enter into a contract for the purchase of cover immediately, it will not make a contract for future delivery. Future contracts seldom run for more than a year; most of them, indeed, run a period of six months or less. The question arises, from whom does the bank purchase its contract for the future delivery of exchange at a specified price? It buys this exchange from the producers who expect to have supplies of exchange to dispose of from time to time in the future.

It may be assumed that an American exporter has contracted to ship foodstuffs amounting each month to £10,000. He wishes to know in advance what price he will be able to obtain for the sterling bills which he expects to draw on his customer each month, in order that he may act intelligently in fixing his selling price. Therefore he enters into an agreement with his bank according to which the latter contracts to purchase his bills at a certain price for each month's delivery. As each instalment of the contract for the delivery of exchange matures, the bank meets its obligation by means of the sterling exchange brought in by the maturing instalment of exchange bought. The profit of the bank consists in the difference between the rate at which it sells the exchange and the rate at which it buys it. Since both contracts

are entered into at the same time and are based on the same rate of exchange, the bank's profit is in no way affected by subsequent fluctuations in exchange rates.

Arbitrage.—Another type of exchange transaction which occurs frequently is that of arbitraging. Since the foreign exchange dealers are in touch with all the markets of the world, they frequently see opportunities to purchase exchange in one foreign market and to sell it in another at a profit, and they are often able to meet their requirements for one kind of foreign currency through purchases in an intermediate market rather than by direct purchases. There may be only three markets involved or there may be many. The essence of an arbitrage transaction consists in buying exchange where it can be obtained cheapest and selling it wherever it will command the best price.

Arbitrage transactions act as a constant force tending toward the establishment of a uniform price in all markets for the exchange of a particular currency. As soon as rates show signs of sagging in one market more than in another, foreign exchange dealers from all outside points enter this market with their orders, and as a result of the increased demand the rates advance. If, on the other hand, a market shows signs of advancing at a more rapid pace than other markets, traders from the other markets seek to sell at the advanced prices and their selling results in bringing the rates back to the common level.

Position Sheets.—To carry on its operations to the best advantage the bank must know positively and quickly, not only where it has funds available abroad and the amounts as of the given day, but also what the status of the balance will be on future dates, as a result of deposits and withdrawals which are in transit on the mail steamers, as well as of the future contracts into which it has entered. To furnish this information the foreign exchange department keeps two "position sheets," the "sight"

position sheet and the "cable" position sheet (Form 17). The purpose of the sight position sheet is to show the amount of the

April, 1921.

	1	2	4	5	6	7	8	9	11	12	13	14	15	16
Banca Commerciale Italiana London	365	750	600 700	600 725	750 600 700					580 430 530			675 335 635	
Farmers Loan & Trust Co. Paris	13400	13200	13350	13150 13000 13200	13850 13700 13900			14950 14800 15000					10400 10250 10450	
Banque National de Greece Athens	75	12 16 25 36 69			150			67 83 113 150 10					98 170 130 160	
Banque Populaire Suisse Zurich	75							69					180	
I. B. C. Yokohama	125													
De Twentsche Bank Amsterdam	17							526 322 377				258		

Form 17. Cable Position Sheet. (Size 27¾ x 18½.)

bank's balance available for drawings by means of sight drafts and drafts of longer maturity. The purpose of the cable position

sheet is to show the balances available abroad for drawings made by cable, together with the changes in this balance which will result as items in transit reach their destination.

Distribution of Foreign Balances.—Both the sight and cable positions are completed at the close of each day and are handed to the traders in the morning for their guidance. Balances that are running low are replenished from those which are becoming excessive, either by ordering the foreign correspondents which hold excessive balances to make cable transfers to those with which the balances are low, or by directing the remittances of the next few days chiefly toward the banks in which balances are low and making the sales of exchange out of the greater balances. Thus the foreign discount department may receive at intervals a list of banks to which they are to send the bills which have been received through their operations. Similarly, those departments which draw drafts in foreign currency are advised as to which banks they are to use for their drawings.

Records of the Foreign Exchange Department.—The books and records of a foreign exchange department vary with the banks concerned, but they all have as their essential purposes: (1) furnishing information as to the amount of the balances in the various banks on a given day; (2) keeping records as to remittances of various kinds; and (3) listing future contracts so as to enable the foreign exchange department to determine what it is likely to have available at specified future dates.

CHAPTER XII

ACCUMULATING EXCHANGE

Sources of Supply of Exchange.—The previous chapter has described the machinery which is organized by banks for the purpose of handling transactions in foreign exchange. The function of that machinery is to accumulate deposit balances with its foreign correspondent and to sell these balances. Or, expressed in the usual terms, it is to accumulate and sell exchange. In this and the succeeding chapter the first phase of this activity, and the ultimate sources of the supply of exchange—which are four in number—are considered.

1. **Exports.**—The most important contributions to the supply of exchange come from the exports. In most cases when the American exporter ships merchandise he draws a draft on the foreign buyer, attaches it to the shipping documents, and sends it to his banker for collection and credit. If the seller of the goods draws a sterling draft he must sell that draft in order to obtain American money. Hence the drafts drawn in settlement of the exportation of goods increase the supply of exchange by the amount of the shipment. Heavy exports to a given country result in increasing the supply of exchange on that country. Bankers and others who desire to obtain exchange are thus able to procure it at a relatively low price because large numbers of exporters offer such bills for sale.

2. **The Sale of Securities.**—The second source of supply is connected with the sale of securities. Before the war, European countries invested heavily in American stocks and bonds. Purchases of stocks and bonds have the same effect on the supply of

exchange as have purchases of goods. The American seller of the securities is paid his money in this country usually by drawing a draft on the foreign buyer and by selling this to an exchange dealer, just as the exporter of other commodities disposes of his drafts.

3. **Borrowing Abroad.**—The third source of exchange supply is derived from foreign loans and finance bills. Loanable funds constantly flow from one financial center to another in order to take advantage of the highest rates of interest prevailing. When an American banker draws on his London correspondent for the purpose of obtaining funds from the English money market to lend in the New York market at the higher rate prevailing, he obtains the funds usually by drawing a sterling draft on his English correspondent and by selling this to exchange dealers in the New York market. These loans are very numerous, and from time to time as they are negotiated they add to the stock of exchange available. It should be noted, however, that these loans provide a supply of exchange only temporarily. When the loans mature in 60 or 90 days they must be paid off. In order to pay them, the American agent goes into the exchange market and buys a bill on the foreign market from some other exchange dealer who possesses a balance. This repayment of the loan then serves to reduce the supply of exchange at such time.

4. **Gold Shipments.**—The fourth main source of exchange is found in connection with gold shipments. Obviously, if a banker ships a quantity of gold to his foreign correspondent and receives credit for the shipment, he has obtained a supply of exchange which is available for sale in the market.

Banking Operations in the Accumulation of Exchange.—All exchange bought or sold arises from one of these sources. However, the immediate and visible form in which the foreign ex-

change department of a bank obtains the funds with which it builds up its foreign balances for exchange purposes, is the subject to be considered here.

The items which go to swell these balances and which actually come into the possession of the bank consist of negotiable instruments of various kinds representing the transactions which have been described.

In considering the banking operations in connection with foreign exchange it is desirable to know how the bank increases its individual stock of exchange. There are three main ways in which its foreign balances are built up: (1) through export foreign collections; (2) through foreign discounts; and (3) through export commercial credits. The first two classes are taken up in this chapter, and the third, commercial credits, in Chapter XIII.

Foreign Collections—Export.—The term "foreign collections" as used in banking includes two classes of items: those which are payable abroad, and those which are payable in this country but which are received for the account of foreign customers of the collecting bank. The first group of these may be termed the "outgoing or export" collections, while the second group are "incoming or import" collections. The terms "export" and "import" as thus used must not be confused with "exports" and "imports" of merchandise. While the large majority of export collections arise from exports of merchandise, and similarly the majority of import collections arise in connection with the importation of goods, the terms "export" and "import" refer to the direction in which the items themselves are headed through the collection process rather than to the type of transaction which originated them.

The foreign collection service of a bank meets three needs of the business world: (1) it facilitates trade and exchange; (2) it bridges the distance between foreign and domestic traders by placing local funds at the disposal of the creditor in exchange for

distant funds; and (3) it converts money of one kind into another, e.g., pounds sterling are converted into United States money, and vice versa

The foreign collection work of those banks which possess numerous foreign correspondents is very heavy because the business which arises in all the banks throughout the country is usually sent to these main foreign exchange banks. Furthermore, the large exporters and importers throughout the country make use of the collection facilities of the relatively small number of banks which possess adequate machinery. In the case of import collections a similar volume of business arises in foreign countries and is forwarded to the main collecting banks in the United States.

Nature of Foreign Collection Items.—The specific items which enter into the foreign collection business consist chiefly of drafts or bills of exchange. But there are also other instruments such as checks, money orders, coupons, matured bonds, coupon checks, certificates of deposit, drafts on savings banks accompanied by bank-books, and travelers' checks. These items arise in connection with transactions growing out of foreign trade, payments for insurance and freight, the purchase and sale of securities, bankers' loans made to each other, remittances by immigrants to persons in the home country, and expenses of travelers.

Transactions which Give Rise to Collections.—One use of the draft which gives rise to a large amount of foreign collection work is that of settling accounts and transferring funds. If a creditor in the United States desires to collect a bill from a foreign debtor, the usual method of settlement is for the creditor to draw a draft upon the debtor. This draft is then deposited with the drawer's bank for collection. A similar use of the draft occurs in cases where one concern wishes to remit money to another. Foreign organizations, such as insurance companies, desiring to remit to

their branch offices in the United States, very frequently instruct the local concern which is to receive the funds to draw a draft upon the home office for the amount. This draft is deposited for collection. Another occasion for depositing a foreign draft for collection occurs in connection with the shipment of goods on a collect-on-delivery basis. This transaction is identical with those domestic transactions which consist of shipping merchandise under an order bill of lading attached to the draft. One of the most common methods of financing foreign trade is by means of the documentary draft. Such drafts with their documents are also deposited with the bank for collection.

Distinction between Foreign Collections and Discounts.—The foreign items just mentioned are handled either on a collection basis or on a discount basis. The process of handling items on a collection basis is very similar in foreign business to the domestic collection business of the bank. The bank acts merely as the agent of its customer and places the proceeds at the disposal of the customer only when payment has been obtained. In accepting items on a discount basis the bank purchases the foreign item from the owner. The customer is given a part of the whole of the face amount of the item less interest for the time which will be required by the bank to collect it. The manner in which these discounts are handled is discussed later in this chapter.

The Work of Export Collections.—In this discussion the work of effecting export collections is considered since it is through these that a bank accumulates exchange. When a bank collects an export item, that is, an item payable abroad, it increases thereby the amount of its balances in foreign banks. The work of making export collections may conveniently be considered in two parts: the handling of the collection items themselves, and the settlement with the customer for the proceeds of the items when collection has been accomplished.

Items are received by the export foreign collection clerks both over the window and by mail. They may originate in the United States or in some foreign country, the essential characteristic being merely that the items are payable in some foreign country. An item received for collection is accompanied by a letter of instruction, and frequently consists of a draft with documents attached. The receiving clerks examine the items and make a record of them, together with instructions of the owner as to the procedure to be followed in their collection and in their disposition in case they are not paid. The documents are then prepared for transmittal to the foreign correspondent of the bank. The correspondent is given instructions as to how the items are to be handled. Duplicates of the letters of transmittal are prepared by the bank, and duplicates of the drafts and documents by the owner; and these duplicates and the originals are forwarded to the bank's foreign correspondent by separate steamers.

The receipt of these items is acknowledged by the foreign collection agent, and if the item be a time draft the American bank is advised when acceptance has been obtained. The local bank, in turn, advises its customer of the acceptance. A record is made of these advices so that the American bank may know when the funds called for by the collection item have become available. If the items are not paid when due, the bank communicates with the collecting agent abroad in the endeavor to hasten collection.

Settlement between Banks upon Payment.—When payment of items has been obtained by the foreign correspondent, the two banks who are parties to the transaction make a settlement between themselves. Such settlements are made according to agreement in one of three ways. The foreign bank may request the American bank to debit its deposit account for the given amount; or, if the American bank maintains a balance with it, the collecting agent may credit the proceeds to the account of the American

bank; or again, the foreign bank may buy a draft on New York for the amount of the item and send the instrument in settlement. If an item remains unpaid in spite of all efforts to obtain payment, it is usually protested and returned to the American bank with reasons for non-payment stated. Contrary to the custom which prevails in handling domestic collections according to which banks do not charge for their services if payment is not obtained, it is the custom in making foreign collections to charge for such services whether or not payment is effected.

Settlement with the Owner of the Items.—When payment has been made and the transfer of funds has been effected from the foreign bank to the American bank by one of the methods described, the American bank settles with the owner of the collection item by crediting his account or by sending a cashier's check for the proceeds. This procedure sometimes involves the conversion of foreign money into domestic currency. Some of the items may have been drawn in terms of foreign money and therefore will have been credited on the books of the foreign bank in terms of such foreign currency rather than in dollars. The rate at which such money is to be converted at the time is obtained from the foreign exchange traders of the bank, and the bank then converts the foreign currency into dollars at this rate and pays the local owner of the item in dollars.

Making Payment for Collections by Cable.—When the customer of the bank desires an especially rapid collection service, there are several methods of handling collections by cable which may be used. The first of these is the cable payment method. Under such arrangement the foreign bank advises the American bank by cable that collection has been effected and that the proceeds are being forwarded by mail, in the case of dollar drafts, or that they have been placed to the credit of the American bank if drawn in foreign currency. Upon receipt of this cable the Ameri-

can bank advises the owner that his items have been paid. He is thus immediately assured that the items have been paid and that he can continue to make further shipments to the foreign buyer without danger of extending too large an amount of credit. Furthermore, if the draft is drawn in dollars, the owner may discount it with the foreign discount department on the strength of the cable announcing payment. If payment has been made in foreign currency the traders furnish a quotation at which the bank will immediately purchase the item. In either case the owner may obtain his funds almost immediately upon the receipt of the cable announcing payment of the collection item.

Cable Proceeds Method; Cable Transfer Method.—The second and third methods for securing immediate payment are the cable proceeds method and the cable transfer method. These methods are identical except that under the cable proceeds method the owner pays the cost of sending the funds, while under the cable transfer method the drawee or debtor pays costs. In making collection on the cable proceeds basis the foreign bank collects from the drawee in the usual way, that is, it collects at the sight rate of exchange on New York. It then deducts from the amount collected the difference between the sight and cable rate, and cables the American bank to make payment to the owner for the amount so obtained. This method virtually amounts to discounting the collection item for the number of days the fund would normally be in transit from the city of the drawee to that of the drawer.

If the proceeds are to be sent by the cable transfer method, the drawee of the draft agrees to pay the amount of the draft, at the cable rate for exchange on New York which prevails in his city at the time of collection. In other words, he pays the draft by purchasing a cable transfer from the foreign collecting bank. When this transfer reaches the United States, the local bank pays the owner the face of the item less the usual collection charges;

i.e., the owner is under no additional expense by reason of the fact that the funds were sent by cable.

Foreign Discounts Increase Supply of Exchange.—The second class of items referred to on page 195, which banks obtain and use for the up-building of balances abroad against which they can sell exchange, is composed of those transactions which are termed "foreign discounts." A foreign discount is in all essentials the counterpart of the domestic discount. It is an advance of funds made by the bank to the owners of bills which are payable some time in the future in foreign countries. These bills are sent abroad to the correspondents of the American bank, and when collected the proceeds are credited to the account of the American bank, thus increasing its supply of foreign exchange. Since the advance made by the bank is a credit transaction, it involves a procedure very similar to the handling of domestic discounts described in Chapters XVII and XVIII.

Discounts in United States and Foreign Currency.—A peculiarity of foreign discounts is that they may be drawn either in dollars or in some foreign currency. If the discount is drawn in foreign currency, it is purchased by the bank at a flat rate of exchange and the transaction is spoken of as a purchase of foreign exchange. If, however, it is drawn in dollars, it is discounted at a given rate and the transaction is called a discount. There is no difference in principle between purchasing a foreign bill at a flat rate of exchange and discounting a bill drawn in United States currency, for the flat rate of exchange is determined by taking into account the length of time the bill has to run and the discount rate for such period.

The Two Phases of Foreign Discount Work.—The work of handling foreign discounts may be divided into two phases: (1) passing upon bills offered for discount, settling with the owner of

those approved, and forwarding the items for collection; and (2) attending to settlements between the bank and its foreign correspondents. Inasmuch as a considerable part of the period that an item has to run is consumed in its transmission to the point of payment, the discounting bank does not hold the items in its possession as in the case of domestic discounts, but forwards them immediately to the collecting agent abroad.

When a bill is submitted for discount the bank makes a complete record of the instrument with the instructions of the customer as to whether he desires it to be protested in case of non-payment. Since the bank relies for the payment of the item ultimately upon its customer, the most important consideration preliminary to discounting the bill is the credit rating of the customer. Persons who expect to borrow regularly on foreign discounts usually receive lines of credit which apply exclusively to such discounts. When an offering has been received by the bank from such a customer, his liability account is consulted to ascertain if the unused portion of his line of credit is sufficient to care for the accommodation asked for. If the line of credit arranged for is exhausted by discounts still outstanding, or if the customer is one for whom no line of credit has been established, the usual application must be made for a new line of credit.

Discounts Accompanied by Documents.—The credit rating of the borrower is frequently supplemented, in the case of foreign discounts, by the documents which are to accompany the bill. These documents convey the title to the commodities shipped and, therefore, so long as they remain in the hands of the bank or its agent they afford additional protection for the advance made. The bank, once it has accepted a bill for discount, becomes in reality the purchaser of the bill. It is therefore of importance to the bank to see that the bill itself and the documents are in proper form so that no formal or technical difficulties will interfere with payment.

Examination of Documents.—The examination of the documents requires a scrutiny of the draft itself to see that it is properly drawn and signed; that the date, the filling, and the amount are in order; and that the amount agrees with that given in the invoice. It must also be noted whether any changes which have been added to the invoice amount to make up the face of the draft are adequately explained. The merchandise invoice is then compared with the bill of lading to see that the mark and description of the merchandise agree. The bill of lading is examined to determine whether the full number of copies certified as having been drawn up by the steamship company are present. This is an important consideration, since a missing document which conveyed title to the goods might subject the bank to the possibility of loss if it should fall into the hands of an unscrupulous person. The bills of lading are examined also to see that they properly describe the merchandise and that they are satisfactorily indorsed to the bank. Insurance certificates are examined to see that the goods are properly protected against damage and loss in transit. If any defect in any of these documents is discovered, the bank communicates with the customer and has the necessary corrections made before its proceeds further with the transaction.

Settlement with Owner.—If the foreign bill is approved and the documents are all found satisfactory, settlement is made with the owner either by discount or purchase or by a loan based upon the collection item. In making a straight discount or purchase, the bank pays the proceeds to the customer at the time the transaction is negotiated, just as it does in the case of a domestic discount. If the item itself is not discounted but an advance is made against its collection, there are two methods of settlement. One method is known as a net settlement; the other a "subject to adjustment" settlement.

If the net settlement is used, the bank advances to the cus-

tomer the face of the bill and collects from the foreign debtor this amount plus all charges; or sometimes it collects the charges from the local customer upon the receipt of the advice of payment from abroad. The "subject to adjustment" settlement is made on a part-payment basis. In such case the bank advances to the customer a portion of the face amount of the item, with the understanding that after the funds have been collected from the foreign debtor the bank will settle with the local customer by deducting its charges and transferring to him the remainder of the amount.

The Conversion Rate on a Foreign Discount.—In the determination of the rate at which the foreign items will be discounted, several separate charges are taken into account. As has been noticed, those bills which are drawn in terms of foreign currency are purchased as foreign exchange, while the bills drawn in dollars are discounted. The rate at which conversion is made when foreign currency bills are purchased is determined by the foreign exchange dealers of the bank. The rate consists of a basic exchange rate determined by the state of the foreign exchange market, and in addition the expenses of the bank for interest, commission, and bill stamps are allowed for. For example, if a customer offers for discount a £5,000 90-day draft on London and the traders quote a conversion rate of 4.69, the proceeds payable to the customer would be the product of £5,000 multiplied by 4.69, or $23,450.

How the Discount Rate Is Determined.—In ascertaining the discount rate four charges have to be considered:

1. The current rate of interest for the time the bank expects to be deprived of the funds.
2. The bank's commission—usually ⅛ per cent for collecting the item.
3. The commission charged by the foreign correspondent bank.

4. The charge for bill stamps as determined by the revenue laws of the country of destination.

The above four items are combined into one rate at which discount is made from the face of the item.

Payment of Discount Charges.—Discount charges, while usually borne by the owner, are sometimes assumed by the drawee. No definite rule prevails in the matter, the procedure depending upon agreement between the drawer and the drawee. If the agreement provides that the drawee is to bear all charges for interest and commissions, the better procedure is for the drawer to include such charges in his merchandise invoice and to draw the draft for the full amount. If the charges are not included in the invoice and the drawee is expected to bear the cost, the bank adds them to the face of the draft.

Difficulties sometimes arise in this connection, however, because of misunderstanding between the drawer and drawee, and this misunderstanding may result in preventing the drawee from accepting and paying the item; whereas, if the collecting agent were expected to collect only the original amount on the face of the draft, collection could be effected. In many countries collecting banks are required to accept payment for the original amount if the drawee is willing to settle on this basis. However, satisfactory service to its customer demands that a bank collect the charges as well, and hence there is always the possibility of misunderstanding in connection with items drawn in this manner.

Discounted Items Forwarded for Collection.—After the bank has settled with its local customer, it sends the item with documents, if any, to its foreign correspondent for collection. The procedure is very much the same as described in connection with foreign export collections. The purpose is to convert these foreign bills of various kinds into actual funds available to the bank

as a foreign balance for the sale of exchange. Since the bank is the owner of the discounted items and may use the proceeds as it sees fit, it may convert the item from one currency to another before sending it on for collection; and it may forward the item for collection and remittance, for collection and credit, or deposit, or for discount and credit.

Drafts drawn in foreign currency are transmitted to foreign correspondents to be credited to the foreign currency account of the American bank. Items drawn in pounds sterling upon persons located in the British colonies are generally rediscounted in the London market. The original items are sent to the British branch bank located in the colonial city of which the drawee is a resident. The duplicate draft and documents are forwarded to the London office of the bank to which the original has been sent, with information in each case that similar papers have been sent to the other office. In this manner the account of the American bank with the London correspondent receives immediate credit for the face of the remittance, because the draft is made payable at the current rate for negotiating in London bills that are drawn on the colonies, together with all charges. The American bank is therefore out of funds merely during the time required for the voyage to London and the drawee meets all charges.

Handling Foreign Currency Items.—Bills drawn in francs, guilders, and marks on persons located in the colonial territories of France, Holland, and Germany are handled in the same way as those drawn in sterling on persons located in London. The original drafts and documents are forwarded direct to the collecting banks in the colonies, while the duplicate drafts are rediscounted in Paris, Amsterdam, or Berlin. Sterling drafts, whether clean or documentary, are sent to the London correspondent of the American bank with instructions either that they be discounted immediately in the London market and the proceeds

placed to the credit of the American bank, or that they be held until such time as the American bank requests that they be discounted. Items held pending instructions as to rediscount are said to be held in "depot" account.

Negotiation of Dollar Items.—Dollar items may be handled in one of two ways: either they may be converted immediately into foreign currency at the prevailing rates; or they may be forwarded for collection with the request that dollars be remitted from abroad. Bills drawn on Australia and British colonies of the Far East are converted, regardless of the length of time they have to run, into sterling at the prevailing check rate on London. There is a market in London for bills drawn on English colonies and especially for those drawn on Australia. Accordingly, a bill running for a given time will be bought and sold at a rate of exchange which takes account of the length of time the London bank will be without funds. In Australia, furthermore, London exchange is more readily obtainable than New York exchange, and the premium to be paid for these two classes of money varies accordingly. Barring violent fluctuations, the Australians invariably prefer to settle their bills in sterling. To the American drawer it makes little difference whether the drawee pays in dollars or sterling. His domestic bank can very readily convert sterling into dollars for him, since there is a wide market for sterling exchange in New York.

Dollar Items Payable at Selling Rate for Sight Drafts.—All dollar items drawn on points other than the British colonies are payable at the collecting bank's selling rate for sight drafts on New York. This means that the drawee is obliged to pay to the collecting bank the same number of pesos, francs, lire, or sterling as he would be obliged to pay if he himself purchased a dollar draft on New York for the full amount of the bill drawn against him. This requirement is important in handling items payable

in countries where the United States dollar passes as legal tender, e.g., Cuba, Porto Rico, Panama, and Santo Domingo. If such instructions were not transmitted with the draft, the drawee might offer in settlement of the bill against him actual United States currency to the amount of the draft. In this event the collecting bank would have to bear whatever expense and loss of interest might be incurred in connection with transmitting the dollars thus collected to New York. The collecting bank would not be satisfied to hold the dollars so received in its vault, and to instruct the New York bank to debit its dollar account carried in New York, inasmuch as the collecting bank is always able to sell at a premium its dollar balances carried with the New York bank.

Settlement between Banks.—When the foreign items have been collected, there remains the problem of settlement by the collecting bank and the bank which originally discounted the item. In choosing its collecting agents, the American bank naturally favors those institutions which carry dollar accounts with it. Settlement then can be made merely by crediting the proceeds of collections to its account abroad, or by debiting the dollar account which the foreign correspondent keeps in the American bank. Sometimes, however, it is necessary to send items for collection to institutions which have no accounts with the American bank. In such event the collecting bank may remit in settlement an approved bankers' check on New York for the required amount.

Treatment of Dishonored Items.—Discount items forwarded for collection are sometimes dishonored at maturity because of some misunderstanding arising between the drawer and the drawee. The collecting agent, through communication with the discounting bank, seeks to make satisfactory arrangement so that the item may be paid. If this proves impracticable, the customer

who discounted the item is required to reimburse the bank for the amount advanced him plus all charges. If the original owner of the item still desires the American bank to attempt to obtain the funds, the item may be accepted on a collection basis and further effort is made to obtain payment.

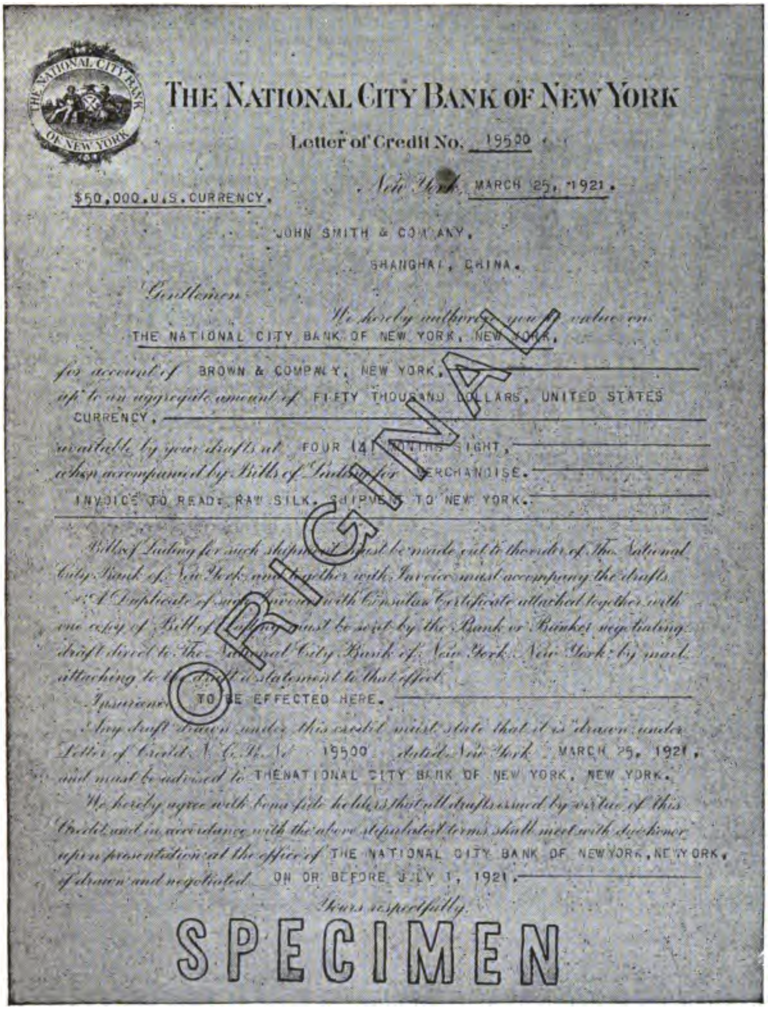
CHAPTER XIII

ACCUMULATING EXCHANGE THROUGH COMMERCIAL CREDITS

Commercial Credits Defined.—The third method (see page 195) by which a bank increases its balance in foreign financial centers is by its dealings in export commercial credits. For those banks which have extensive international connections commercial credits represent one of the most important forms of bank credit.

A commercial credit, or a commercial letter of credit, may be defined as an instrument drawn by a bank in behalf of one of its customers, authorizing another bank to make payments or accept drafts for a fourth party when the last-named party has complied with certain stipulated conditions. While commercial credits may be used at times in all transactions involving transfers of funds in both domestic and foreign business, by far their most important use is in financing imports and exports of commodities.

A Typical Commercial Credit Transaction.—The nature of a commercial letter of credit can best be understood by tracing an imaginary transaction. Assume that a grain exporter in the United States makes a shipment of grain to an English importer. The American shipper knows little about the credit rating of the importer and wants to be sure of getting his money if he ships the grain. Accordingly he requests the English buyer to open a letter of credit (Form 18) in favor of the American exporter at one of the London banks. The buyer arranges with a London bank where his credit standing is well known, to issue a letter of credit in favor of the American exporter, authorizing the latter to draw drafts upon the London bank's American correspondent,



THE NATIONAL CITY BANK OF NEW YORK

Letter of Credit No. 19500

$50,000 U.S. CURRENCY.

New York, MARCH 25, 1921.

JOHN SMITH & COMPANY,

SHANGHAI, CHINA.

Gentlemen:

We hereby authorize you to value on THE NATIONAL CITY BANK OF NEW YORK, NEW YORK,

for account of BROWN & COMPANY, NEW YORK,

up to an aggregate amount of FIFTY THOUSAND DOLLARS, UNITED STATES CURRENCY,

available by your drafts at FOUR (4) MONTHS SIGHT,

when accompanied by Bills of Lading for MERCHANDISE.

INVOICE TO READ: RAW SILK. SHIPMENT TO NEW YORK.

Bills of Lading for such shipment must be made out to the order of The National City Bank of New York and together with Invoice must accompany the drafts.

A Duplicate of such Invoice with Consular Certificate attached together with one copy of Bill of Lading must be sent by the Bank or Banker negotiating draft direct to The National City Bank of New York, New York, by mail, attaching to the draft a statement to that effect.

Insurance TO BE EFFECTED HERE.

Any draft drawn under this credit must state that it is "drawn under Letter of Credit N. C. B. No. 19500 dated New York MARCH 25, 1921, and must be advised to THE NATIONAL CITY BANK OF NEW YORK, NEW YORK.

We hereby agree with bona fide holders that all drafts issued by virtue of this Credit and in accordance with the above stipulated terms shall meet with due honor upon presentation at the office of THE NATIONAL CITY BANK OF NEW YORK, NEW YORK, if drawn and negotiated ON OR BEFORE JULY 1, 1921.

Yours respectfully,

SPECIMEN

ORIGINAL

Form 18. Commercial Letter of Credit. (Size 8½ x 11.)

the accommodation to run for a specified period and for the amount of the shipment. The London bank advises the American bank of its action. When the exporter ships the grain he draws a draft upon the American correspondent bank, attaches the shipping documents to it, and presents the draft to a local bank for discount. The instrument will be discounted at a very favorable rate because it is drawn on a bank and when accepted becomes a prime bankers' bill. After the exporter has received his money the transaction for him is closed, except for his contingent liability to the discounting bank as drawer of the draft. The bank which discounted the bill forwards it with documents to a correspondent bank, to be presented to the drawee bank for acceptance. When the drawee bank accepts the draft it obtains possession of the documents covering the shipment and sends them to the London bank which issued the letter of credit. The London bank in turn releases the documents to the importer so that he can obtain the grain shipped.

When the draft matures it will have to be paid by the drawee, that is, the American bank. It is necessary for the English importer to provide the funds with which the American drawee bank may meet its acceptance on the due date. The London bank which issued the letter of credit is responsible to the American bank for the payment of the draft, and the importer is in turn responsible to the London bank. He pays the amount of the draft to the London bank and this bank in turn credits the proper amount to the American correspondent. The American bank then pays the draft when it matures, and the transaction is completed.

In essence a letter of credit is a guarantee on the part of a bank with an established credit rating to be responsible for credit extended under specified conditions to one of its clients.

Advantages to Buyer and Seller.—The usefulness of commercial credits is therefore obvious. From the standpoint of the

seller of goods such instruments constitute a convenient means of exchange, in that the shipment is paid for at the time of its despatch to the buyer. The seller is also relieved of the uncertainties of extending credit to the buyer. The function of extending credit is shifted to the buyer's bank, which presumably is best fitted to pass upon his credit standing. The seller has the added assurance that, if he has followed the terms of the credit and of his contract with the importer, he will be protected from complaints, adjustments, and cancellations on the part of the buyer.

From the point of view of the importer the commercial letter of credit offers two distinct advantages, although it puts the responsibility of financing importations upon him. One of the advantages is that he can be reasonably sure that the shipment will be made in conformity with his desires as expressed in the letter of credit. Another advantage is that he does not need to pay for his commodities until the maturity of the draft. He can obtain release of the merchandise by signing a trust receipt, under the terms of which his bank turns over the commodities to him, and is thus able to pay the draft out of the funds received from the sale of the goods.

The Banks' Profits.—The banks which are parties to these transactions obtain their profits in the form of commissions. In addition to these commissions, banks which do a large international banking business participate in buying, discounting, and collecting the foreign exchange items which arise from these credits. The banks, it should be noted, lend only their credit, since they do not part with any money during the operations of the exchange until they have been paid by other parties. The funds are obtained in the last analysis from the discount market of the country in the currency of which the draft is drawn.

Dollar Credits—Foreign Currency Credits.—Letters of credit may be classified according to the kind of exchange involved.

Thus there are dollar credits, sterling credits, franc credits, and so forth. The determining factors in the choice of the currency to be used are the facility and economy with which drafts drawn in a given currency can be discounted in the holder's market. These factors depend upon the exchange rate and the conditions prevailing in the discount market of the drawee.

Clean and Documentary Credits.—Commercial credits may be classified as clean and documentary credits. The credit is termed documentary when the beneficiary is required to present certain documents to the negotiating bank before he can obtain payment or acceptance of his draft. A credit is termed clean when the beneficiary's draft is to be honored by the negotiating bank on presentation with the letter, even though unaccompanied by any documents. Documentary credit is generally used to cover shipments of goods title to which can readily be passed by negotiable documents, while clean credits are used to cover such transactions as the transfer of funds from a firm or corporation to its agent or branch in some other country.

Revocable and Irrevocable Credits.—As to the obligation of the parties, credits may be classified as revocable or irrevocable. An irrevocable, or confirmed credit is one which cannot be canceled or modified without the consent of all the engaging parties. The revocable, or unconfirmed credit, on the other hand, is issued with the understanding that both contracting parties reserve the right to cancel it at any time.

Credits Classified by Method of Payment.—Commercial credits may be classified further according to the method which the paying bank uses to settle with the beneficiary. The letter may be a straight credit, an acceptance credit, a negotiation credit, a guarantee credit, or an authority-to-purchase credit.

The straight, or sight credit authorizes the beneficiary to

collect a sight draft drawn on the paying bank. An acceptance credit authorizes the beneficiary to draw a time draft and have it accepted. A negotiation credit is one in which the negotiating bank does not become the drawee of the draft; the beneficiary draws upon the buyer, and the negotiating bank is instructed to negotiate or to discount the draft for him.

Credits may be guaranteed in one of two ways: (1) The paying bank, on the strength of the guarantee of a foreign bank, simply advises the exporter that his draft up to a certain amount will be honored abroad; it assumes no obligation for payment under this method, and the beneficiary must receive his funds from the issuing bank or from the importer. (2) The paying bank issues its own guarantee that the beneficiary's drafts will be honored abroad.

Under the authority-to-purchase credit, the bank advises the beneficiary of the credit and stands ready to purchase his drafts, with or without recourse to him, at their face value. An authority-to-purchase credit drawn without recourse is often spoken of as a bankers' credit.

Reimbursement Credits.—Another form of credit is the reimbursement credit. Usually the two banks which are concerned as principal parties in the transaction settle with each other by means of charges and credits to their accounts maintained with each other. In some cases, however, a bank of unimpeachable credit standing may designate some bank with which it does not maintain an account to be paying agent under one of its credits. A credit opened under such circumstances is termed a "reimbursement" credit because of the peculiar way in which the paying bank reimburses itself for its outlay. The bank makes the required payment to the accredited party in the funds of his country. It then draws a draft upon the issuing bank for the equivalent amount in foreign currency. This draft is forwarded for collection to one of its correspondents located in the vicinity of the issuing bank.

Fixed and Revolving Credits.—Another classification of credits may be noted: fixed or "non-revolving," and "revolving" credits. The non-revolving credit is issued for a maximum amount, against which drawings may be made by the beneficiary. As each draft is drawn, the amount of the credit is diminished by the amount of the draft. When the whole amount is exhausted, the credit ceases to exist. The revolving credit, on the other hand, is not exhausted by drawings; it represents rather a continuing obligation of the bank to meet, within a definite term, drafts up to a certain maximum amount outstanding at any one time. It sometimes happens, however, that banks renew or extend credits which have become exhausted. When this is done the renewal is generally issued in the form of an authority-to-purchase credit.

Types of Revolving Credits.—There are several forms of revolving credits. The most common form permits the beneficiary to draw drafts for various sums and at various times. These drafts temporarily exhaust the credit, but as they are paid the proceeds are restored to the credit for future use. A second form enables the beneficiary to draw a certain amount in one draft. When the bill has matured and has been paid a similar sum may be drawn, and so on until the term of credit has expired. A third form permits the beneficiary to draw up to a certain amount periodically. This form may be cumulative or non-cumulative. If cumulative, such portions as were authorized for previous periods but were not drawn are available for drawing in later periods. If the credit is non-cumulative, drawings authorized for a previous period cannot be used at a later time.

Import Commercial Credits—Bank Operations.—The duties performed by a bank in the handling of commercial credits vary according to whether the bank acts in the capacity of the issuing bank or in that of the paying or accepting bank. When a bank

opens a credit upon the application of an importer—that is, when it acts as the issuing bank—it performs such operations as:

Passing upon the credit rating of the importer.

Making arrangements with the applicant as to the terms of the credit.

Making arrangements with the foreign correspondents to pay or accept the drafts of the exporter.

Receiving documents from abroad as import shipments are made.

Arranging for the release of the documents to importers.

Collecting from the importer.

Making settlement with the paying or accepting bank.

Bank Operations under Export Commercial Credits.—When an American bank acts as the paying bank on the request from a foreign bank to make advances to American exporters, under terms of a letter of credit issued by the foreign bank, it performs such duties as: receiving advice of credits opened, advising the beneficiary of the credit, making advances to the beneficiary as he uses the credit, and reimbursing itself for these outlays. The operations performed by the issuing bank constitute what might be termed the import phase of the transaction; the operations performed by the paying bank constitute what might be termed the export phase. Banks accumulate exchange through the operation of export commercial credits.

Export and Import Credits—Proportion.—With respect to export commercial credits American banks act as paying agents, just as the foreign banks act in that capacity with respect to credits issued through the import commercial credit operations of American banks. As there is a greater flow of commodities out of the United States than into it, the volume of work connected with export credits exceeds that connected with import credits. The large favorable balance in the foreign trade of the United

States during the past few years is reflected in the types of credit which have predominated in the work of these two divisions.

March 25, 1921.

When referring to this credit, please mention our No. 55555

American Coal Co., Inc.,
200 Broadway,
New York City.

Dear Sirs:

We are pleased to inform you that we have been requested to open a credit in your favor under the terms and conditions stipulated below:

Opened by Copenhagen Laane og Diskontobank, Copenhagen, Denmark, cable 3/24/21.

Account P. Frausing Broedrene

Amount Up to $26,000.

Available by draft at sight on us bearing credit no. F. E. 55555

Covering About 3,250 tons of coal, per sailing vessel "Slaven" from Newport News to Korsoer.

NOTE: All insurance covered abroad.

Drafts drawn under this credit must be presented not later than April 11, 1921 unless sooner revoked.

Documents required:
Full set ocean bills of lading issued to order and blank indorsed.
Plain invoice in triplicate.

AMOUNT OF CREDIT

Cable 4/2/21 - increase to $30,000

CHARGE A/C OF Above bank

SPECIAL INSTRUCTIONS.

Cable rec'd 3/28/21 - authorizes us to pay advances to the Captain of the "Slaven" up to the amount of $5,000. out of the credit amount.

EXTENSIONS

DISPOSITION OF DOCUMENTS

CANCELLED BY DATE

Form 19 (a). Beneficiary's Card or Credit Advice (face). (Size 8½ x 10¾.)

During recent years the exports have so largely exceeded the imports, and there has been such a demand for American products

abroad, that the exporter has usually been able to require cash payments. Accordingly, most of the export commercial credits have been straight credits, whereas import credits have much more frequently taken the long-time acceptance form.

Opening an Export Credit.—The first step in handling export commercial credits is the receipt of a letter of credit from the American bank's correspondent giving the details concerning the particular transaction. Many of such details conform to general

DATE AND AMOUNT OF PAYMENT				DOCUMENTS SENT							
Paid to	Credited to										
	AMOUNT			B/L	Ins. Cert.	Invoice	Con. Inv.	Spec. of Weight	Cert. of Origin	Draft	
Apr. 5.	29 545	60	Covering 3,270 tons Pocahontas coal shipped per sailing vessel "Slaven" from Newport News to Korsoer, B/L dated 4/3/21. Charges amounting to $4,500 for advances to Captain.	1/3		1/3		1			

Form 19 (b). Beneficiary's Card or Credit Advice (reverse).

instructions in effect between the bank and its foreign correspondents. The signature appearing on the letter is then verified, inasmuch as the instrument is in effect a draft payable in instalments. An investigation is made to ascertain whether the balance of the foreign bank or firm opening the credit is sufficient. In the case of a confirmed credit the total contingent liability of the foreign bank or firm, under letters of credit already outstanding, is also determined. After these steps have been taken, the letter of credit is sent to an officer of the bank for approval. If it is approved, the beneficiary is advised (Form 19) that the credit in his favor has been opened, and the foreign correspondent is informed likewise that the credit has been granted in accordance with its instructions.

Examination of Documents.—When the American exporter has prepared his shipment, he presents to the bank the documents stipulated in the letter of credit together with his draft for the proper amount. Before payment can be made to him care must be taken to see that the documents are all in order, and that all conditions specified in the credit have been complied with. Documents are checked against specifications of the shipment as to price, quantity, and nature of the merchandise. Insurance certificates, bills of lading, and other documents are checked to see that all copies are in the possession of the bank, and to be sure that they bear no qualifying marks such as "Bags torn," "Contents shifting," or any other qualifications which might impair the strength of the bill of lading.

Payments under Export Credits.—If everything is in conformity with the terms of the credit, the amount to be paid under this particular transaction is deducted in order to show the amount still outstanding on the credit, if any. The documents are then forwarded to the foreign correspondents, and settlement is made with the customer. Payment may be effected in the case of a straight credit by means of a cashier's check or a credit to the customer's account; in the case of an acceptance credit, by accepting a draft in his favor.

Domestic Commercial Credits.—Letters of credit may also be used to finance domestic shipments. This happens when goods are to be transported from the interior of the country to the seaboard, where railroad bills of lading are to be exchanged for ocean documents and the shipment sent forward under foreign letters of credit. For example, an exporter located in New York City may open a domestic letter of credit in favor of a manufacturer in Chicago. The latter loads his produce on the cars and receives railroad bills of lading, which he presents with his draft to the Chicago bank in conformity with the terms of credit. When he

obtains his money, his part of the transaction is finished. The Chicago bank forwards the documents to the New York bank and the latter hands the railroad bills of lading to the exporter who has established the credit, in exchange for a trust receipt. When the shipment arrives in New York the exporter gives up his railroad bills of lading and obtains possession of the goods. He has them loaded on a steamer and receives ocean bills of lading in return.

The exporter must now provide the funds for liquidating the domestic letter of credit. Usually he is the beneficiary of a credit opened by the foreign importer of goods, and under this arrangement he presents the documents to the bank and applies such a portion of the proceeds as is necessary to cover the draft drawn under his domestic letter of credit. The exporter in such cases reaps his profit without employing any of his own money in the transaction.

Summary.—The purpose of this chapter and the preceding one has been to show the manner in which a bank builds up its foreign balances, or, in other words, accumulates a stock of exchange against which it may sell drafts and other items. As already explained, three kinds of transactions provide the materials for augmenting the bank's foreign balances: export foreign collections, foreign discounts, and export commercial credits. In all these transactions a bank exchanges funds in America for funds in some foreign center. In the case of foreign collections, the bank does not pay out the money at home until the funds abroad have been received, or have been credited to its foreign account. In the case of foreign discounts the American bank exchanges funds in this country for funds to be received later abroad. In the case of export commercial credits it exchanges funds in the domestic markets on the strength of the guarantee on the part of a foreign bank to be responsible for the payment of the funds abroad at a specified time in the future.

CHAPTER XIV

SELLING EXCHANGE—IMPORT COLLECTIONS AND FOREIGN DRAFTS

Ultimate Sources of Demand for Exchange.—Having discussed the banking machinery for trading in foreign exchange and the manner in which the supply of exchange is accumulated by a bank, there remains the task of showing the sources of the demand for this exchange, or, in other words, the sale of exchange by banks. Just as, in connection with the supply of the general stock of exchange, the ultimate sources of the supply were first considered, so here it will be desirable first to consider the ultimate sources of the demand for exchange, after which the forms in which the demand comes to a bank will be discussed.

Demands for foreign exchange grow out of transactions which may be arranged in five main groups:

1. The first source of demand for exchange is in connection with the importation of commodities. An American buyer, for example, purchases goods in France. In paying for them he may choose: (a) to send gold; (b) to buy from a banker or other exchange dealer the use of a portion of such person's foreign balance with which to make the payment; or (c) to make temporary settlement by giving his promise to pay in some form at a future time. It should be noted that the last method is merely temporary; at some time in the future, resort must be made to one of the other two forms of settlement.

2. The purchase of foreign securities by American investors, or the purchase of American securities owned by foreigners, increases the demand for exchange, because the buyer must transmit the funds for the payment of his purchase to the country from which the securities were bought. Hence such transactions

increase the number of persons in the United States who wish to buy foreign exchange. It should be remembered that, while there is always the option of shipping gold in payment, this is rarely done, those having claims to meet preferring to meet them by the purchase of exchange unless the price of exchange is prohibitive.

3. A considerable demand for exchange arises from banks with international affiliations and in connection with the operations of making foreign loans. When an American banker desires to lend money in the London market, the usual method by which he transfers funds to London is by exchanging his money in New York for a bill of exchange on a London bank balance.

4. Payments of interest and dividends on securities held abroad, settlement of freight bills due to foreign shipping concerns, and payments for insurance premiums due to foreign insurance companies, all necessitate the exchanging of money in this country for money in the foreign centers, and hence increase the demand here for balances which are maintained abroad.

5. Remittances by immigrants to their friends at home and expenditures made by tourists traveling abroad increase the demand for foreign exchange. Each of these transactions involves the giving up of money in this country in exchange for a draft, travelers' check, or other instrument which will give the holder abroad the right to draw money from bank balances accumulated there.

Banking Transactions in Connection with These Demands.—The above five groups of transactions illustrate the fundamental sources of demand for exchange. Practically all demands for bills of exchange can be traced to one of these groups of transactions. Banks which engage in trading in foreign exchange are constantly buying and selling bills which have originated in one of these ways. This discussion involves more particularly the manner in which these calls for exchange come to the bank and

an understanding of the banking transactions which reduce the stock of exchange possessed by a particular bank.

The banking transactions involved may be grouped under four main heads:

1. The collection for foreign correspondents of items payable in America.
2. The sale of foreign drafts and cable transfers.
3. The sale of travelers' checks and travelers' letters of credit.
4. The commitments of the bank under import commercial credits.

The first two classes of transactions are discussed in this chapter, and the other two in the following chapter.

Foreign Import Collections.—Foreign import collections, or "import collections" as they are more frequently called, are similar to the export collections described in Chapter XII except that they are payable in the United States instead of a foreign country. They consist of items which have been accepted by foreign banks in their collection or discount service and which have been sent to American banks for collection. All import collections are payable in the United States. They are usually received by the American bank through the mail, but they may be presented at the window in case the foreign concern presenting them for collection has an agent or branch in the United States.

The American bank's stock of exchange is depleted by such collection activities because, after obtaining the funds from the American debtor, settlement must be made with the foreign bank which forwarded the items. This settlement is made usually by authorizing the correspondent to charge the credit balance of the American bank for the amount, or by remitting the amount to the correspondent by means of a draft drawn on an account maintained by the American bank in some other foreign bank.

Items Accepted by Import Collection Department.—The kinds of items handled by the import collection department are drafts, notes, checks, or similar negotiable instruments. These items may be divided into two main groups: cash items and collection items. The distinction between the two groups is the same as that made elsewhere—cash items are those collections the proceeds of which are to be credited to the account of the sender on the day of receipt; whereas collection items are those deposits which are not yet due, and which are therefore to be credited only after the funds called for have been received.

Cash items are handled in much the same way as an ordinary deposit, that is, they are distributed to the bookkeepers, the clearing house racks, and the transit department, according to the banks upon which they are drawn. The foreign customer is advised in the usual manner that his account has been credited for the amount. If any items are later returned unpaid, reimbursement is obtained by charging back the unpaid items and advising the customer of this action.

Handling of Import Collections.—The collection items include bills drawn in foreign currencies, time bills, documentary drafts, and communications in which the bank is requested to make delivery of valuable papers and documents only upon receipt of specified payments. In the case of incoming collection items drawn in terms of foreign currency, the bank first makes conversion of the face amount into United States currency, since that is the form in which the local debtor makes payment to the bank. The amount he must pay in local currency to settle for the item is determined by obtaining the conversion rate either from the foreign exchange traders of the bank or in the exchange market.

When the import collections are received, the cash items are separated from the collection items, and each of the latter documents is assigned a serial number, which becomes the identification number for the particular transaction. A collection register

is kept in which are entered information as to the customer from whom the item has been received; the person to whom it is to be credited; its amount, tenor, date of maturity, and place of payment; the documents and instructions relating to it; and its final disposition. The incoming foreign collection items require the same sort of attention and collection service as is given domestic collections described in Chapter IX. For this reason those items are turned over to the domestic collection employees. Time items are held after acceptance until maturity, when they are presented for payment.

Discounting Import Collections.—Some of the import items may be discounted at the wish of the foreign customer. Many foreign banks have standing instructions with their American correspondents to discount collection items for them from time to time, in amounts sufficient to restore their balances, in case these balances fall below a certain specified amount. In other cases the bank itself assumes the responsibility for discounting import collection items, placing the proceeds to the credit of customers whose accounts show an overdraft, in order to bring the account back to a credit balance. These discounts are handled in the same manner as domestic discounts.

Settlement with the Foreign Bank.—When the bank receives payment for a foreign import collection item, settlement must be made with the foreign owner, or rather with the foreign bank in which the collection item has been deposited. If the foreign bank is a correspondent of the American bank and maintains a reciprocal account with it, settlement may be made by crediting the amount to the foreign bank or by authorizing that bank to debit the account of the American bank with a similar sum. If the American bank does not carry an account with the foreign bank a sight bill of exchange on one of its foreign correspondents may be drawn and forwarded to the creditor bank.

If items are not paid after they have been presented, the owner is notified. If he has filed any instructions with the bank as to procedure in such case, this procedure is followed. It is often possible to adjust differences between the drawer and drawee and thus obtain payment. As soon as it has been definitely established that a collection will not be paid, the item is returned to the owner, or to the bank acting for him, with an advice to the effect that his account has been debited with the expenses incurred in the attempt to make collection. These expenses include protest fees, bill stamps, cable charges, and a small commission for the effort to collect.

Selling Foreign Drafts.—The second group of transactions (see page 224) which reduce a bank's stock of exchange includes those arising in connection with the sale of foreign drafts, cable transfers, and letter transfers. The use of bank drafts or bankers' checks to transfer funds from this country to foreign countries is very widespread. These drafts may be drawn either in foreign currency or in dollars, according to the contract between the buyer of the draft and the payee. Foreign currency drafts are the more commonly used. When remittance is made in the form of a dollar draft, the foreign payee bears the risk of fluctuations in the exchange rate. Such drafts, however, are usually stamped "Payable at the buying rate in (the financial center to which they are forwarded) for sight drafts on New York." This insures the payee the most favorable rate for cashing the draft.

Cable Transfers.—A cable transfer corresponds to the telegraphic transfer within a country. The cable transfer method presents certain important advantages to those who have payments to make. The first advantage is that by this means funds can be transferred to a foreign center within a few hours. This rapidity of transfer enables the remitter to wait before making his payment until the day his account is due abroad; thus he has

the use of his funds during the days or weeks required for the transmission of a sight draft. If he purchased a sight draft he would have to pay the local bank for it eight or ten days before the maturity of his obligation abroad.

A second advantage of the use of cable transfers is that by waiting to settle his account until the last day the remitter is able to watch the fluctuations in the rate of exchange. If the rate is high on the day he would ordinarily be compelled to purchase a sight draft for mailing, he can wait until more favorable rates are obtainable, provided he remits by cable in time to meet his account when due.

Letter Transfers.—A letter transfer (Form 20) consists of a form letter addressed to a foreign bank by an American bank, requesting the foreign bank to make certain stipulated payments against duplicate receipts and identifications, and to charge the account of the American bank for such payments. Applications for letter transfers are received in the same manner as for drafts, and reimbursement is made to the bank by the applicant in the same way. Letter payments are frequently used to open accounts for clients who are planning to reside abroad for some time. The usual form of letter payment is drawn up and specimens of the client's signature are enclosed to facilitate authentication of the checks which he may draw against the foreign account.

The arrangement differs from the clean credit in that funds are actually deposited in the foreign bank for the use of the client at his pleasure, and the foreign bank pays his checks out of this deposit in the same manner as it pays those of its regular depositors; whereas, in the case of a clean credit the foreign bank negotiates the customer's draft at the buying rate for sight drafts on New York, and reimburses itself by forwarding this draft to New York for collection. The foreign bank prefers the letter payment method because it has the use of the funds which are deposited, while the American bank is deprived of the total amount from

the time the transaction is made. In the case of a clean credit the American bank generally has the use of the funds until payment is actually made abroad.

THE NATIONAL CITY BANK OF NEW YORK
FOREIGN TELLERS

ORIGINAL

NEW YORK Sept. 16 1921

TO National City Bank
Bogota, Colombia

No. D 1898

Kindly make the following payments to our debit, upon identification, and against receipts in duplicate to be forwarded to us. TOTAL: 5,000.00

NUMBER	BENEFICIARY	ORDERED BY	DESCRIPTION	AMOUNT
7467	M. M. Miller	R. W. Wylie	Same	5,000

THE NATIONAL CITY BANK OF NEW YORK
John Doe a/c
John Roe P.P.

Form 20. Letter Transfer or Foreign Payment Letter. (Size 8 x 6.)

Drawing on Non-Correspondents.—Other transactions which reduce the foreign balances of the American bank are orders addressed to foreign correspondents who pay out portions of the bank's balance in a manner similar to the procedure followed when a depositor draws his check upon a local bank. A somewhat different transaction but one which also reduces the foreign balance of an American bank, is that of a request to a bank for a draft upon some bank located in or near the place to which a remittance is to be sent, but in which the American bank does not carry an account. The American bank draws on an institution located conveniently for the beneficiary, but, as the drawee bank cannot reimburse itself by charging the account of the American

bank, the latter is obliged to furnish to the former some means of reimbursement before the draft is presented for payment. This may be done in one of two ways. With the notification to the drawee bank that a draft upon it has been issued, the American bank may enclose a sight draft upon one of its own correspondents in the vicinity and payable to the drawee bank. The other means of reimbursing the drawee bank is to request it to draw a sight draft in its own favor upon one of the near-by correspondents of the American bank in question, specifying the name of the correspondent upon which the draft is to be drawn.

Types of Bills Sold—The Long Bill.—Still another type of bill which depletes the American bank's stock of foreign exchange is issued when there is (as in normal times) a considerable demand in the New York market for 60- and 90-day bills. An importer may find himself well supplied with funds but with no foreign obligations maturing for two or three months. He does not wish to have these funds idle but he desires to be prepared to meet his payments when due. To keep these funds employed he anticipates his payments by purchasing long-time bills, and thereby receives the advantage of the lower rates prevailing for such drafts; the saving thus effected may be regarded as interest on the money invested. He is therefore receiving interest on his money and at the same time ready to settle his account when it becomes due. Or the importer may foresee a rise in the value of a foreign currency before his payment is due. This would make it advisable for him, if he has idle funds, to purchase his exchange for future remittance before the maturity of his foreign debts. When these long bills sold by the bank mature, they are charged to its account and thus reduce the bank's foreign balance.

Actual Demands on the Bank—How Met.—The demands for facilities for making foreign payments come through the personal application of traders, travelers, investors, and others who wish

to settle accounts abroad, as well as from banks in the interior of the country which have no direct connection with foreign banks. In the latter case the interior banks are sometimes permitted to draw drafts on the foreign correspondents of a metropolitan bank. These foreign banks charge the account of the American bank, the latter in turn receiving reimbursement from the domestic banks.

A bank which provides this service to domestic correspondents furnishes them with a booklet giving the names of its foreign correspondents, and containing draft forms stamped with the name of the domestic bank, and a rate sheet showing the rate of exchange which the domestic bank is to charge its clients. These rate sheets are changed from time to time, the frequency depending upon the extent of the changes in the market rates. The bank's exchange rates are slightly above the market quotation, since the rates quoted for this business are applicable for drawings only up to the equivalent of $1,000. The charge to the purchaser of the draft is made up of three elements: (1) the face of the draft in dollars, (2) the charge of the foreign bank for cashing the item, and (3) the commission charged by the local selling bank. The city bank furnishing the service makes its profit from the exchange transaction; that is, it charges a somewhat higher rate of exchange than it pays in the market.

The Application Form.—When application is made for a foreign draft the bank requests its customer to fill out an application form, giving his name and address, the name and address of the foreign payee, and the amount and kind of currency desired. The application is accompanied by money, certified check, or cashier's check for the amount, or by instructions to debit the applicant's account with the bank if he has one. In the latter case the signature on the application is certified, and the bookkeeper in charge of the account is instructed to hold a portion of the balance sufficient to cover the draft.

Determining the Selling Price.—When the application has been received and approved, the selling price is computed. In selling dollar drafts the American bank makes its direct profit in the form of a commission, which is added to the face of the draft to make up the total cost. In issuing a foreign currency draft no direct commission is charged; the cost of the draft is expressed in the number of dollars obtained by converting the face amount at a rate of exchange sufficiently high to include commission.

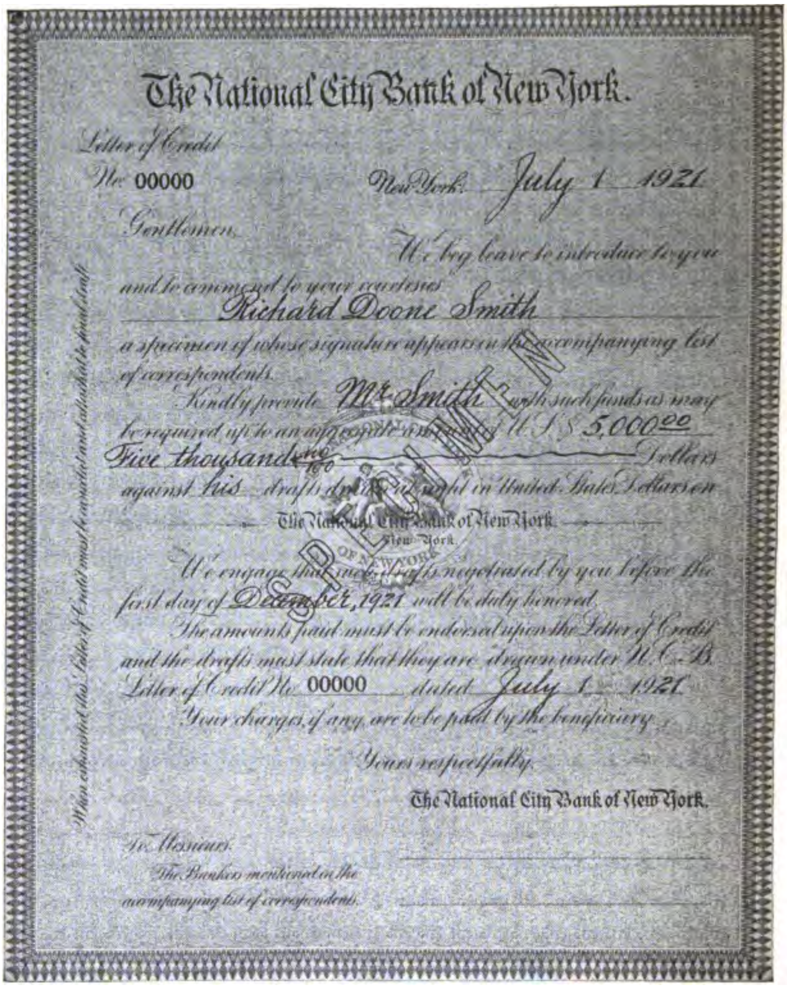
The rates of conversion for foreign currency drafts are fixed by the foreign exchange traders of the bank. For large drafts individual quotations are made; for small ones the rates are furnished to the employees on a daily rate sheet. The foreign exchange traders of the bank also determine which of its correspondents are to be drawn upon. In the case of large items the traders are consulted as to the disposition of each one; but for small items the employees making up the drafts follow their own judgment, subject to instructions which are furnished at intervals by the traders, indicating the banks that are to be drawn upon during the ensuing week. A report showing the volume of drafts and letter transfers drawn on each correspondent is furnished to the traders, so that they may avoid the risk of making overdrafts on some correspondents while the balances in other banks near at hand remain relatively large.

CHAPTER XV

SELLING EXCHANGE—TRAVELERS' CREDITS AND COMMERCIAL CREDITS

Travelers' Letters of Credit.—A third group of transactions which deplete the bank's stock of exchange (see page 224) are those connected with the issue of travelers' letters of credit and travelers' checks. A travelers' letter of credit (Form 21) is an instrument drawn by a bank, which authorizes certain of its correspondents to advance funds up to a specified amount on the demand of a designated beneficiary. The method by which the beneficiary usually obtains funds in such case is by drawing a draft on the issuing bank or on certain of its correspondents and collecting on this draft from some bank where he happens to be when he needs the funds. The letter of credit is therefore in effect an authorization to draw drafts in instalments against the issuing bank. Such drafts are sometimes also termed "circular letters of credit." They differ from the commercial letters of credit or commercial credits chiefly because of the fact that the latter are used to finance the exportation and importation of commodities.

Travelers' Checks.—A travelers' check (Form 22) is a special form of cashier's check adapted to the use of travelers. Such checks differ from the ordinary cashier's check, however, first, because they are issued in specified denominations such as $25, $50, or $100; whereas cashier's checks are issued for any amounts that may be requested and not necessarily even amounts. Another distinction is that the travelers' check contains a specimen of the signature of the owner, whereas the cashier's check does not. The buyer of a travelers' check signs it in the presence of an



The National City Bank of New York.

Letter of Credit

No. 00000 New York July 1 1921

Gentlemen,

We beg leave to introduce to you and to commend to your courtesies

Richard Doone Smith

a specimen of whose signature appears in the accompanying list of correspondents.

Kindly provide Mr Smith with such funds as may be required up to an aggregate amount of U.S.$ 5,000.00

Five thousand 00/100 Dollars

against his drafts drawn at sight in United States Dollars on

The National City Bank of New York

New York.

SPECIMEN

We engage that such drafts negotiated by you before the first day of December, 1921 will be duly honored.

The amounts paid must be endorsed upon the Letter of Credit and the drafts must state that they are drawn under N.C.B. Letter of Credit No. 00000 dated July 1 1921.

Your charges, if any, are to be paid by the beneficiary.

Yours respectfully,

The National City Bank of New York.

To Messieurs

The Bankers mentioned in the accompanying list of correspondents.

When exhausted this Letter of Credit must be annexed and attached to the final draft

Form 21(a). Travelers' Letter of Credit (face). (Size 8½ x 11.)

officer of the issuing bank when he buys the check, and it is validated by his signing it a second time in the presence of the person who is to cash it. If the signatures agree, this fact is presumed to establish the identity of the beneficiary and his right to cash the check. A third difference between a travelers' check and the circular letter of credit or the travelers' letter of

PAYMENTS MADE UNDER THIS LETTER OF CREDIT MUST BE INSCRIBED ON THIS PAGE AND MUST NOT EXCEED IN THE AGGREGATE
Five thousand DOLLARS, U. S. CURRENCY

DATE	PAID BY	AMOUNT IN WORDS	IN FIGURES
			$

Form 21 (b). Travelers' Letter of Credit (reverse).

credit is that each travelers' check is payable as a whole, while a letter of credit is payable in instalments according to the wishes of the beneficiary. A travelers' check may be described as a type of bank note which is worthless until the owner has countersigned it.

The two instruments described above are in wide demand both for domestic and foreign travel. They offer a convenient and safe method for travelers to carry the money which they expect to need during the journey. It is usually a difficult matter for an individual to have his checks cashed at a distance from his home, and if he is traveling in a foreign country this method of obtaining funds is of course impracticable. Travelers' checks and letters of credit, however, may be used in practically all parts of the world. So far as the issue of letters of credit and travelers' checks to be used within the country is concerned, a large number of banks have facilities for selling them; but only a comparatively few metropolitan banks possess facilities for the issue of letters of credit and checks to be used in foreign countries.

Form 22. Travelers' Check. (Size 9 x 3¼.)

The principal New York banks, especially, handle a large amount of the business for the smaller interior banks.

Examples of Use of Letters of Credit.—The use of a letter of credit may be thus illustrated: Suppose a traveler holding a dollar letter of credit of a New York bank needs funds when he has reached Naples. The correspondent in that city, as named in the list of correspondents of the issuing bank given with the letter, is, say, the Banca Commercial Italiana. The traveler presents the letter at that bank and requests payment of $100. The Italian banker prepares a draft of $100 on the New York bank and has the holder of the letter sign it. The traveler writes his signature in the presence of an officer, who compares it with the signature which the holder of the letter inscribed upon his list of correspondents when that list was issued to him by the New York bank. If the signature is satisfactory the Italian bank pays the equivalent of $100 in Italian currency, at the prevailing rate for sight drafts on New York. A record of the payment is made on the reverse side of the letter and thus the document constantly shows the balance remaining to be drawn. The draft is then sent by the Italian bank to its correspondent in New York or to the issuing bank itself for collection and credit.

In case the credit issued is in terms of sterling and the traveler desires £100, the Italian banker prepares the draft for this amount to his order on the reimbursing London bank named in the letter of credit. He then pays the traveler in Italian money the equivalent of £100 at the prevailing rate for sight drafts on London. The draft on London is sent by the Italian bank to its London correspondents for collection and credit. The London bank compares it with the signature and information which it received from the issuing bank after the letter of credit was sold, and if these details are satisfactory the draft is paid and charged to the account of the American bank.

Advantages of Travelers' Checks.—While a letter of credit is honored usually only by the correspondents named in the list which accompanies it, travelers' checks are freely accepted by banks, hotels, railroads, and business houses throughout the world. At the time of purchasing the checks the owner signs all of them in the upper left-hand corner. When he wishes to obtain funds he again signs the check to be cashed in the lower left-hand corner in the presence of the person who is to pay it. If the signatures agree it is perfectly safe for anyone to advance the funds. It is apparent that the counter-signature of the holder should not be placed upon the check until he wishes to use it and then only in the presence of the person who is to cash it.

Expiration and Renewal of Letters of Credit.—When the holder of a letter of credit has drawn all the funds called for by such letter, the bank cashing the last draft retains the letter and forwards it, attached to that draft, to the American bank; there the letter is filed. The letters run for a definite period of time and usually expire when this time has elapsed. When expired or exhausted letters of credit are returned to the issuing bank, they are canceled and filed. An expired letter of credit may be renewed upon the application of the holder if the issuing bank is willing, but the applicant is required to sign an application and to submit the same information and guarantees that were required for the original issue.

Lost Letters of Credit and Travelers' Checks.—If a traveler loses a letter of credit he follows the directions given with the list of correspondents. The procedure varies somewhat with the type of letter involved, but to stop payment on the letter cable messages must be transmitted between the beneficiary and the issuing bank, and between the issuing bank and correspondents. Such communication involves considerable cost for cabling, amounting to, say, from $50 to $75. If a travelers' check is lost,

the owner notifies the issuing bank or the bank through which he purchased the check, making application for reimbursement for the amount lost. He must then sign an indemnity bond, agreeing on his side to reimburse the issuing bank for any loss which it may incur through being obliged to pay the lost check. When the issuing bank is satisfied as to its protection in this manner, the face amount of the lost check is returned to the owner. Payment is stopped on the lost check, as in the case of an ordinary check. If the check is presented for payment, the issuing bank refuses to honor it, provided the transaction can be traced to the correspondent which paid the check without exercising proper diligence. The correspondent must then look for recovery of the amount from the person who cashed the lost check.

Types of Credits and Checks.—There are several types of letters of credit and travelers' checks. Letters of credit are issued either as dollar credits or as foreign currency credits. A dollar credit authorizes the holder to draw drafts in dollars, while a foreign currency credit authorizes him to draw in the currency of some foreign country. Formerly sterling credits were used almost exclusively by Americans traveling abroad, because sterling drafts could be cashed at the best rates. In recent years, however, dollar credits have become much more generally used by the American traveler. Travelers' checks are issued in American currency, and are convertible in normal times into foreign currencies at fixed rates of exchange. When the rate of exchange fluctuates considerably, they are made convertible at the prevailing rate for sight drafts on New York.

Paid Credits and Guarantee Credits.—Letters of credit may be issued also in other forms, according to the wish of the holder or the method of paying the issuing bank. Thus a letter of credit may be a paid credit, or a guaranteed credit.

A paid credit is issued for cash or its equivalent. The cost of such a credit is the face amount of the dollar instrument, or, in the case of a foreign currency, the dollar equivalent of the foreign currency, converted at the current rate of exchange. In each case there is added to this face amount a commission, customarily ½ per cent.

In the issue of a guaranteed credit the applicant for the credit pays the issuing bank only when the bank actually makes outlays to meet drafts drawn on the credit. The buyer of such a credit furnishes a written guarantee that he will pay the drafts as they are presented. The charges for credits of this kind are the face amount of the separate drafts plus the usual commission. In issuing foreign currency credits which authorize drafts to be drawn on foreign banks, the American bank adds an interest charge at a specified rate, for the number of days required for the draft to reach New York from the place of business of the drawee bank. The reason for this interest charge is that, whereas the drawee bank debits the account of the issuing bank at the time of paying the draft, the issuing bank, however, does not reimburse itself from the guarantee until after the draft has reached New York. The interest charge is designed to pay for the use of the funds between the time the American bank makes the advance abroad and the time when it collects the amount advanced from the guarantor in America.

Collateral Credits.—Another basis upon which letters of credit are issued is the deposit of collateral with the issuing bank. This transaction is very similar to the guaranteed credit, and reimbursement to the bank is made in a similar manner. The chief difference is that the holder of the letter furnishes collateral in the form of securities to support his guarantee. Letters of credit may thus be paid for by the applicant either in advance or in instalments as the money is drawn, whereas travelers' checks are always issued for cash.

Specially Advised Credit and Circular Credit.—Letters of credit may be classified further according to the arrangement in effect between the issuing and paying bank or banks. Thus the credit may be either "specially advised," "circular," or a "clean" credit. A specially advised letter of credit is addressed to one particular bank. The holder is able to secure funds only from such bank. If the holder expects to remain in one place for a considerable length of time while abroad this form is advantageous, because if such a letter should be lost payment can readily be stopped, inasmuch as there is only one place where payment can be obtained.

A circular letter of credit involves three parties or groups of parties so far as the banks are concerned, viz., the issuing bank, the drawee bank, and the listed correspondents. Under this form of letter the holder is given the choice of drawing drafts upon any of the drawee banks mentioned in the letter. These names generally include one or more of the large correspondents of the issuing bank in London, Paris, and Berlin. If the item is a dollar credit, the drafts are to be drawn upon the issuing American bank itself.

The list of correspondents comprises those banks which will act as agents to cash such drafts as the traveler may find it convenient to make. The names of the correspondents are recorded in a booklet which accompanies the letter of credit. If the letter is addressed to all the foreign correspondents of a large bank, covering practically all the nations of the world, it is termed a "universal" letter of credit. Usually the bank obtains a list of countries which the traveler expects to visit and it then furnishes a list of correspondents containing only those foreign banks upon which the traveler is likely to call for funds.

Clean Credits.—A clean credit is similar to a travelers' credit. A credit of this sort is usually opened by cable with one correspondent, and is a request to this correspondent to honor sight

drafts drawn by the beneficiary up to the amount of the credit. This form of credit is very similar to a deposit account opened by an American bank for its customer with a foreign bank. An American bank naturally prefers the clean credit to the deposit account, inasmuch as in the case of the deposit the foreign bank has the use of the funds until they are drawn, whereas under the clean credit either the American bank or the customer has the use of the money. A clean credit may be payable in instalments at the convenience of the customer, or payments may be restricted to specified amounts periodically. These periodical payments may be cumulative or non-cumulative.

In so far as the relations between the issuing bank and the paying banks are concerned, travelers' checks are very similar to dollar circular credits in that they are drawn on the issuing bank and are negotiable with all its correspondents. No special list of correspondents is given with travelers' checks inasmuch as the form of the instrument insures wide acceptability. Both letters of credit and travelers' checks reduce the stock of exchange which the American bank has accumulated, since the correspondent banks in foreign countries must be reimbursed for payments made by them, either by a charge to the American bank's deposit account or by remittances from time to time of foreign bills forwarded by the American bank.

Application for Letter of Credit.—When a customer desires to obtain a letter of credit, he makes a formal application stating the name of the beneficiary, the amount of the credit, the date of expiration, and the countries or cities in which the credit is to be used. The applicant agrees that in case the letter is lost, immediate notice to that effect will be given by telegram. He agrees further that he will immediately reimburse the bank for all expenses incurred in connection therewith, and for all payments made under the letter of credit before actual notice of loss is received by the agent making such payments. The application

also states the method which is to be used in paying the bank, and the applicant submits specimen signatures of the beneficiary.

If the applicant desires a guaranteed letter of credit, the credit rating of the guarantor is important. This rating must be passed upon by the credit man of the bank and by the proper officer before the letter can be issued. If the applicant pays cash, this of course is unnecessary.

After the application has been approved the letter of credit is prepared on regular forms, specifying the amount, the date of issue, the name of the beneficiary, and the expiry date—which is usually one year from that of issue. The list of correspondents is furnished, and this contains a specimen of the holder's signature, constituting his means of identification. If the application is for a guaranteed credit the customer is required to sign the guarantee.

How Travelers' Checks Are Issued.—The issuance of travelers' checks is a simpler matter since they are issued in exchange for cash. The purchaser merely fills out an order form specifying the amounts and denominations of checks he desires, and signs his name. He inscribes his signature in the upper left-hand corner of each check immediately so as to protect himself in case he loses the checks.

Letter of Credit Service to Country Banks.—Since the demands upon most of the smaller banks throughout the country for letters of credit and travelers' checks are not large enough to make it worth while to issue their own forms, many of these banks rely on the facilities of large city correspondents. For example, a city correspondent may send to its country correspondents a supply of travelers' checks and letters of credit, which the country banks hold under a trust receipt. The letters of credit are already signed, numbered, and stamped with the maximum amount for which they may be drawn. When the country bank issues such a letter of credit it advises the city correspondent of

the fact and sends along with the advice specimen signatures of the beneficiary, together with its guarantee and a check or instructions to charge its account for the amount issued. When travelers' checks are sold the country bank also advises the city correspondent of the sale. The advice contains the name of the bank making the sale, the name of the purchaser, the numbers appearing on the checks sold, and a remittance for the amount.

Foreign Currency Letters of Credit.—When letters of credit drawn in foreign currency are issued, it is necessary for the American bank to advise the foreign banks of the issuance of such letters, inasmuch as these documents require that drafts be drawn on certain foreign banks. The issuing bank therefore furnishes its foreign correspondents periodically with information of the issuance of such letters, so that they may know when to expect drawings. The advice gives details as to the various letters of credit issued and is accompanied by specimen signatures of the beneficiaries.

Cashing Credits and Checks—The Bank's Responsibility.—Letters of credit and travelers' checks having been issued, there remains for the bank of issue the task of paying for them as they are cashed. Drafts drawn under letters of credit come to the bank from abroad in the usual manner of foreign collections and deposits. When they are received these instruments are compared with the bank's records and, if found correct, drafts drawn under a paid letter of credit are charged to the Cash Letters of Credit account, thus reducing the bank's liability under these instruments. If the draft is drawn under a guaranteed credit the guarantor is expected to pay the amount. Accordingly a bill is sent to the guarantor for the face of the draft plus interest and commission charges; or if he has an account with the bank, this account is debited and he is advised of the fact.

Travelers' checks return to the bank either directly from out-

of-town banks or through the clearing house. They are compared with the bank's records and, if satisfactory, the Travelers' Check account is debited for the amount.

Import Commercial Credits.—The fourth group of transactions which make demands upon the stock of exchange owned by an American bank (see page 224) are those which grow out of import commercial credits. The general nature and purpose of commercial credits has been discussed in Chapter XIII. Import commercial credits, it will be recalled, are credits which are arranged by American banks for American importers who, by their importations of commodities, incur the obligation to pay sums of money abroad. The characteristic feature of the transaction is that the American bank assumes the obligation of paying to the foreign seller the amount due from the American importer —looking to the importer for reimbursement.

An import commercial credit reduces the foreign balance of an American bank, since the letter of credit usually authorizes the foreign creditor to draw drafts on the correspondent of the American bank in some foreign center; and the bank then either suffers a depletion of its balance, if it happens to have a balance with the drawee bank, or falls under the necessity of remitting exchange to such bank. Later the American bank recovers the amount, as already noted, from the American importer, so that in essence what the American bank does is to exchange funds in its possession abroad for funds paid to it at home.

The Process of Granting an Import Credit.—The handling of import commercial credits includes such operations as:

Passing upon the credit rating of the importer.

Making arrangements with the applicant as to terms of the credit.

Making arrangements with the foreign correspondent to pay or accept the draft of the exporter.

Receiving documents from abroad based on import shipments.
Releasing documents to importers.
Collecting from the importers.
Making settlement with the paying or accepting bank.

The Credit Rating of the Applicant.—The first step to be taken when an application for an import commercial credit is made, is to pass upon the credit rating of the applicant. This is essential; the bank is going to guarantee to honor drafts if drawn in accordance with the terms of the credit and must rely on the importer to make payment.

The next step consists of drawing up the agreement between the bank and its customer. This document states whether the drafts are to be drawn in dollars or in foreign currency, and is evidence of the fact that the applicant agrees to furnish the bank with funds at least one day before the maturity of dollar drafts drawn under the credit; and twelve days before the maturity of foreign currency drafts if he agrees to pay at the check rate, or one day before maturity if he agrees to pay at the cable rate. The applicant gives a lien on the goods covered by the credit, and agrees, if requested, to give security before the bank surrenders documents representing the merchandise imported.

Advice to Foreign Bank.—The letter of credit is then prepared and the foreign bank which is to act as the paying or accepting agent is advised either by formal letter or by cable of the issue of the letter and of its terms. The foreign bank notifies its customer that a credit has been opened in his favor. The foreign exporter then proceeds to draw his draft and to dispose of it through his bank and the local money market.

The commodities are prepared for shipment and the shipping documents are attached to the draft in conformity with the terms of the credit. These documents are forwarded to the American

bank where they are examined with great care to see that the shipment corresponds with the terms of the credit. Since the American bank is to act as the paying agent for its customer, it is required to follow carefully his instructions as embodied in the letter of credit. When the bank is satisfied that the shipment is as expected, it reimburses the foreign bank for its payment.

Settlement between the Banks.—Reimbursement may take the form of authorizing the foreign paying bank to charge the account of the American bank, or it may be effected by a remittance of exchange. Under the majority of dollar credits reimbursement is made by accepting time drafts. In fact, foreign trade transactions are the chief source of bankers' acceptances in the United States. Under this method the bank does not advance any money for the customer but merely agrees to accept a draft drawn upon it. When this has been accepted, the draft is discounted and held until it matures. By that time funds from the importer are in the possession of the bank and with these it pays its acceptance.

In the case of all import credit transactions, whether issued in dollars or in foreign currency, the documents are carefully guarded inasmuch as they give protection to the bank for the ultimate payment of the credit by giving it control of the merchandise shipped. As the importer naturally desires to get possession of the goods, so that he can dispose of them and obtain the funds with which to reimburse the bank, the documents are delivered to him under a trust receipt. This gives the bank a prior lien on the shipment as security until the importer's payment has been made.

If the customer's application for a commercial credit is guaranteed by another bank, the issuing bank frequently releases the documents on the strength of such guarantee, without requiring a trust receipt to be executed. If the transaction involves a dollar credit and the bank's advance consists of an acceptance

running for some time, this acceptance is paid off by the American bank in the usual manner. If it has been held by some bank in the locality of the issuing bank, it may be collected through the clearing house at maturity. It may come in for payment through the mail or over the counter, or it may be handled through the collection or transit departments of the bank.

Liability Records Kept for Each Customer.—The issuing bank keeps a careful record of the liability of each customer, showing the total number and amount of credits issued for him as well as the payments that have been made thereunder. Since the bank has guaranteed to make payments for these accounts, the unused balance on each credit constitutes a contingent liability of the bank. Records are also kept of the full details of each letter of credit and of every drawing under it.

Since these operations involve the use of the bank's supply of exchange at one time or another, a list is compiled showing the requirements for foreign exchange for some weeks in advance. This list is used by the foreign exchange dealers of the bank to enable them to ascertain their position and to make provision for a supply of exchange when needed.

Summary.—The four groups of transactions discussed in this and the preceding chapter all call for sales of exchange. How this exchange is accumulated by American banks is described in Chapters XII and XIII. In transactions involving import collections, the American bank collects for foreign correspondents items which are payable in the United States. In settling with the foreign collecting agent the American bank's account with some foreign bank is depleted. Funds are received in America, and in exchange funds are made available abroad. In selling foreign drafts, cable transfers, and letter transfers the American bank also gives funds deposited in foreign banks in exchange for money received in the United States. Letters of credit and travelers'

checks in effect give permission to the holders to draw upon the foreign balances of the American bank, and in exchange it receives local funds. Finally, import commercial credits deplete the foreign deposit balances of American banks, because they authorize foreign sellers of goods to Americans to draw on the foreign accounts of American banks in settlement of these commercial debts.

CHAPTER XVI

EXTENDING CREDIT

Credit Defined.—One of the most important functions of the modern bank is the manufacture of credit. Credit might be defined as the privilege of immediate use of economic goods, granted in exchange for the promise to return goods of an equivalent value in the future; or it might be put more briefly as the exchange of present goods for future goods. Credit is one of the media of exchange. A simple example will make this clear.

An individual goes to a merchant and buys a quantity of goods for which he agrees to pay at some time in the future. The merchant has thus exchanged his present goods for the promise on the part of the buyer to return to him an equivalent amount of goods in the future. This is manifestly a credit purchase and the merchant may be regarded as extending credit. To go back of this transaction and consider the purchase of these goods made originally by the merchant, it will be found that in the majority of cases that also is a credit transaction.

The merchant buys a stock of goods from a jobber or wholesaler, but at the time has not the money to pay for them. The jobber or wholesaler, however, needs his money in order to obtain another supply of goods himself. The merchant goes to his bank and borrows a sufficient sum of money to pay for his goods, giving his promise to the banker to repay him an equivalent amount of goods in the future. The banker has in this case exchanged present goods, money—or its equivalent, an entry on his ledger in favor of the borrower—for the promise on the part of the merchant to return an equivalent amount of money in the future. The banker has thus extended credit.

Credit Involves Risk as Well as Futurity.—Every credit transaction involves futurity and hence involves a certain amount of uncertainty. The merchant who sells goods on credit and the banker who extends credit to the merchant, both relying on repayment in the future, are, it might be said, relying on uncertainties, since the developments of the future are always uncertain. But in each case the person who extends the credit seeks to reduce the uncertainty as much as possible—to eliminate all the known elements which make it unlikely that he will receive his payment in the future. Hence the granting of credit calls for expert knowledge of conditions and complete information regarding the beneficiary of the credit.

The Bank as a Credit-Making Machine.—It has been said that modern banks manufacture credit. The word "manufacture" is used here in a somewhat figurative sense, to indicate that banking facilities and machinery increase the stock of credit, or rather they increase the velocity of the circulation of credit. An individual or an institution may grant credit without manufacturing it. Thus, if a bank accumulates deposits of a million dollars from various individuals in its community and then loans the million dollars in various sums to other individuals, it is granting credit and is acting as the intermediary between the borrowers and the real lenders, that is, the depositors. But it has not increased the amount of credit available. It lends merely the amount that has previously been deposited with it.

The process of manufacturing credit consists essentially of giving to several persons the right to use the same funds. This seems paradoxical but if one stops to realize the manner in which the funds of the bank are used it will not be so puzzling. Except in rare instances, depositors in a bank do not use actual money for the settlement of their commercial transactions. For the most part they effect transfers of funds by means of checks, as has been pointed out earlier in this volume. Funds are trans-

ferred thus by bookkeeping entries, and cash is needed only for the less usual transactions in which depositors actually present their checks and ask for money.

The Cash Reserve.—Experience has shown bankers that if they keep a moderate amount of cash on hand they will always be prepared to care for the relatively infrequent demands of customers for cash. Each banker is able to determine, from his own experience and from general conditions of the business community around him, the amount of cash which will suffice for the demands of depositors. In this country, in order to assure depositors that banks will always have a sufficient amount to meet their requirements, the law specifies the minimum amount of cash to be kept by banks in proportion to deposits—which is known as the "cash reserve." This legal reserve is, however, only a minimum requirement. Those banks which are members of the federal reserve system must keep the entire legal reserve on deposit in the federal reserve banks. Necessarily, therefore, they carry in their own vaults a supply of cash in excess of their legal reserve, since they must keep some supply to take care of the immediate needs of customers. Thus in practice each bank maintains a total cash reserve in accordance with its particular requirements, as disclosed by experience rather than as demanded by statute.

The possibility of manufacturing credit, or, as was said before, of giving to a considerable number of persons the right to use the same funds, is the chief source of profit for the bank. The limits of the bank's power to manufacture credit are fixed by its possibilities with respect to a cash reserve.

Economic Importance of Credit Extension.—The modern commercial bank performs an extremely important economic service in thus increasing the use of credit. If one stops to consider the comparatively small number of transactions in which

cash settlement in full is made originally, and the great extent to which reliance is placed upon credit, it will be realized that any agency which makes possible the increased use of the important tool of credit is of inestimable value to the business world. Credit, serving as a medium of exchange, facilitates the transfer of goods from place to place and from person to person. Anything which facilitates the exchange of goods thereby increases the possibilities of the division of labor and as a result increases production. The wants of modern society could by no means be satisfied if it were not for the minute division of the labor of their production, which exists mainly because of the facilities for exchange, which in turn are largely dependent upon a large and effective use of credit.

Responsibility of Bankers for the Use of Credit.—Since credit enters to such an important extent into industrial and commercial activities, it can readily be seen that its use must be guarded with great care. As the bankers are the chief custodians and dispensers of credit, the responsibility for its proper use rests upon them. If, in their desire to increase profits, they extend credit too liberally, they foster an inflation of the medium of exchange which will have disastrous effects. If they grant credit to those who, because of lack of ability or integrity are not entitled to it, not only are those persons who could make wise use of it hampered in their productive activities, but the borrowers are likely to fail to meet their agreement to repay their loans and thus cause large losses to the bank and to the community. This failure will not only bring suffering and hardship upon individuals who may lose their savings through faulty judgment on the part of the banker, but it may result, if these failures become numerous, in the precipitation of a commercial and industrial panic or depression, with all the accompanying ill effects.

Bankers are entrusted with the funds of large numbers of people, because they are presumed to be honest and skillful in the

handling of financial affairs, and because it is assumed that they have the facilities for ascertaining the capability and reliability of those who wish to use credit. As specialists in credit, upon them devolves the responsibility of safeguarding and directing its use, so that it may come into the hands of those who will employ it most effectively.

Character of a Bank Determined by Its Credit Relations.—The manner in which banks permit the use of credit is determined to a very considerable extent by the kind of credit the bank receives. As previously said, the bank is an intermediary or a dealer in credit. When a depositor leaves money with the bank, the bank becomes by that process a debtor to the depositor. When the bank in turn extends credit to others, these customers become debtors to the bank. Banks receive two main kinds of deposits: demand deposits, or those which are payable on demand; and time or savings deposits, those which are payable only after a specified period of time, or for the withdrawal of which a bank may require a certain number of days of advance notice. If a bank has received deposits which it knows must be paid upon demand, it must make its loans to customers in such form that it may readily liquidate them to obtain cash to meet the demands upon it. On the other hand, if it has deposits which are expected to remain in its possession for long periods, it will make long-time loans or investments. From this point of view, there are two types of bank: the investment bank, and the commercial bank.

Investment Banks.—Investment banks are: (1) savings banks which do not receive deposits subject to check and which therefore are able to make loans on long-term mortgages, or to advance credit to corporations through the purchase of bonds; (2) trust companies and similar institutions which are engaged chiefly in the underwriting of security issues; (3) specialized investment banking institutions, organized for the purpose of financing

particular lines of business activity. Farm loan banks, cattle loan associations, and foreign trade promotion banks are examples of the third type. The funds obtained by the borrowers from banks of the investment type are used as fixed capital for the purchase of plant, machinery, real estate, the improvement of road-bed, and other permanent betterments.

Commercial Banks.—The commercial bank, on the other hand, advances credit for short terms. The kinds of credit instruments it obtains are usually promissory notes, running for not more than 90 days, and acceptances. The funds advanced by commercial banks are used as working capital or fluid capital to purchase merchandise and raw material, and to pay wages and other expenses of production. The assumption is that the loans of a commercial bank will be self-liquidating—that is, the money to repay such loans will be obtained through sales of goods, services, or through other current operations. Commercial banks may be further subdivided, from the point of view of the kinds of credit they advance, into agricultural, mercantile, and industrial banks.

The distinction between savings banks and commercial banks has become somewhat blurred in recent years because practically all the commercial banks, so-called, have added savings departments, and in some states the title of "savings bank" is given to institutions which differ in scarcely any respect from the usual commercial bank.

Commercial Banks Provide Production Credit.—The kind of credit advanced by commercial banks is usually production credit, that is, credit which is used for the production of additional goods. Such credit may be contrasted with consumption credit—credit extended for the purpose of purchasing goods for immediate consumption. Banks prefer—and it is usually much more to the interest of the community—that credit be extended for production purposes rather than for consumption purposes.

If the funds borrowed are used for further production, the productive process will yield values out of which the loan can be liquidated; but if the money loaned is used merely to purchase consumable goods, there is less likelihood that when the loan matures there will be sufficient funds at hand to pay it. While there may be legitimate reason for borrowing temporarily for the need of consumption, more often persons who borrow for the sake of spending or consuming goods are regarded as less desirable credit risks, since they apparently are so lacking in thrift and business judgment as to live beyond their means.

The Credit Rating of the Applicant.—The first step in lending the bank's money, therefore, is the determination of the credit standing of those who apply for loans. Formerly lending was mainly local, and bank officers were chosen because of their knowledge of the standing of prospective local borrowers. With the increasing size of business units, as typified by the growth of corporations, and with the more intimate trade relations between all parts of the country and all parts of the world; and furthermore because of improvements in means of transportation and communication, extensions of credit are made over a much wider area and the necessity for the exercise of careful judgment on the part of the banker has become even more imperative.

The standing of a borrower depends upon two factors; his ability to pay, and his willingness to pay. His ability to pay is determined: (1) by the use that he makes of funds advanced to him—whether he uses them wisely and effectively or not; (2) and by the kind of goods he is preparing to market. Certain staple goods, such for example as agricultural products, coal, or iron and steel, have a wide and ready market of a sort which is not enjoyed by seasonal goods or products which might be classed as luxuries. Hence, in advancing credit a bank tries to satisfy itself in advance, so far as it possibly can, that the borrower will make wise use of the funds and that he will produce commodities

for which there will be a market; thus disposing of his goods and obtaining the money with which to pay off the loan at maturity.

The second factor upon which a borrower's credit rests is his willingness to pay. This depends upon his integrity, or upon the pressure which the bank can bring upon him when his loan matures. The bank seeks to advance credit only to those of the highest standing from the point of view of honesty. Furthermore, whenever possible to do so, it prefers to retain possession of a stock of commodities belonging to the borrower sufficient to repay the loan, until the funds are actually in hand to pay it. The ascertainment of these facts, and the determination of the credit standing of a prospective borrower, require such careful investigation that they can be satisfactorily performed only by those who have become experts in this field. It is the function of the credit department of a bank to determine on this basis the credit rating of those who are applicants for loans.

The Credit Department.—The size of the credit department varies, of course, with the volume of credit business handled by the bank. The extension of credit may be left to one or two officers in the case of a bank of moderate size, or in a bank of large size a separate department may be created with a great many employees. In the largest banks the work may be so heavy as to necessitate a division in the department, one section determining whether credit is to be granted and the other taking care of the transactions after the general decision has been made.

The particular function of the credit department is to make investigation regarding credit risks, and to file in convenient form the information it obtains, so that officers of the bank may be able to estimate the worthiness of an applicant for credit, and so that the credit information will be available when the bank is in future asked concerning the credit rating of one of its customers. The employees in the credit department are divided frequently into three main groups, the work of which in each case is: (1) to

gather information, to put it into proper form, and to keep it up to date; (2) to analyze credit information in order to appraise the credit standing of prospective borrowers; and (3) to furnish service to the customers of the bank by giving them reliable credit information.

1. **Sources of Credit Information.**—Considering first the collecting of information, it may be said that there are six main sources of information regarding the credit standing of applicants for loans: banks; the trade; the applicant himself; credit agencies; newspaper clippings; and past relations with the applicant. In using every available source of information the credit department of a bank finds it extremely valuable to call upon other banks for information in regard to the applicant. So far as the confidential nature of the information which they possess permits them to do so, banks in the United States exchange credit experiences quite freely with each other. Every bank from time to time obtains credit information from other banks through correspondence and through personal interviews. Where banks possess foreign branches the credit departments of these branches are drawn upon in regard to foreign applications for credit.

An important source of credit information consists of those who buy and sell merchandise, or who have other business dealings with the particular person or prospective customer to be investigated. By exchanging information with the chief commercial concerns in the country, a bank is enabled to obtain very reliable information concerning the habits and the credit rating which an applicant enjoys in his business relations.

One of the most important sources of information is naturally the applicant himself. It is the usual practice for customers desiring a line of credit at a bank to give the bank complete financial information about themselves; and in many cases indeed they seek the bank's advice as to how to improve their credit rating. Correspondence and personal interviews are used to elicit

the information, but more important is the financial statement prepared by the applicant or his accountants. By analyzing such statements and keeping them on file the bank is enabled to obtain accurate information as to the standing of the customer.

A source of credit information is found in the reports furnished by commercial credit agencies, such as Dun's, Bradstreet's, Seyd's, and others. In addition to this credit information the bank frequently maintains a clipping bureau, which obtains from newspapers and periodicals such information as death notices, notices of dissolution of firms, changes in capitalization, lawsuits, judgments, bankruptcy proceedings, and similar data. Newspapers and trade publications are read carefully with the special purpose of obtaining information which may be of value in determining the amount of credit to extend to customers. Some banks record facts which come to their attention regarding the personal life and habits of depositors even though they have made no recent application for credit. The purpose is to keep informed as fully as possible regarding the factors which might influence the judgment of the bank officials in extending credit.

Finally, the bank should consider whatever past relations it may have had with the applicant. The average balance of the customer, the amount of borrowing which he has done in the past, whether or not he overdraws his account and to what extent, the profitableness of the account, the promptness with which he has met previous obligations—all these data combine to furnish a reliable index as to the applicant's desirability as a borrower.

Assembling the Credit Information.—From these various sources credit information is assembled and prepared for analysis. Sometimes the information is tabulated on cards or in books, but more frequently it is assembled in a credit folder. The typical credit folder consists of several sections for the filing of information as enumerated below:

1. The fly sheet shows the name and address of the applicant;

the line of business he is engaged in; the date the account was opened; the name of the person by whom the applicant was introduced; the name of the officer who accepted the account; accounts maintained with other banks; the name of the note-broker, if any, through whom paper is sold in the open market; the names of the indorsers whose support the applicant has agreed to secure in his borrowings; and finally a statement as to the line of credit extended to the concern or person by the bank.

2. A statement section contains the original statements furnished by the applicant together with the summaries prepared by the credit department of the bank. These statements may be submitted on the applicant's own form, but more frequently the statements are made in a uniform manner according to plans which have been worked out by the federal reserve banks. A comparative statement, prepared by the bank, shows the applicant's condition from year to year. A summary statement gives the date total, quick assets, current liabilities, ratio of quick assets to current liabilities, fixed liabilities, total liabilities, net worth, annual sales, and net profits.

3. The third section of the folder contains clippings from newspapers and periodicals, and various reports that have been received from banks, the trade, and other references which have been given by the applicant or which have been consulted by the banks. Reports of interviews which the bank's representatives have had with the applicant are also included.

4. In the inquiry section all letters of inquiry which the bank receives from other parties regarding the applicant's credit standing are filed, and with them copies of the replies made by the bank.

5. Two other sections contain reports received from commercial credit agencies and the correspondence relating to loans which the bank has had with the subject of the folder.

These folders are so filed that they can be readily consulted. To prevent the confidential information contained in the files

from coming to the attention of unauthorized persons, the folders are kept strictly in the possession of file clerks, who are permitted to give them out for examination only upon requisition signed by an officer of the bank or by a responsible member of the department.

Revision of Information.—The information contained in the folders is revised regularly and on special occasions as need arises. A progressive credit department requires a regular revision of the information accumulated in connection with each borrowing account at least once a year, and more frequently when information is received which affects the credit standing of the subject. Special effort is made to have the regular revisions occur at the latest moment preceding the period of large borrowing by the customer. When this is done, the bank is equipped with the latest possible information before making the loan.

2. Analysis of Credit Information.—The second main function of the credit department is the analysis of the credit information received. The primary purpose of maintaining the credit department is to enable it to give information and advice to the officers of the bank which will assist them in determining whether applicants for credit ought to be accommodated. The final analysis of the information as well as the ultimate decision regarding the granting of loans must, of course, be made by the officers of the bank.

The three points principally considered in analyzing a credit risk are the character, capacity, and capital of the applicant. Of these three the last is perhaps of least importance, chief attention being directed to the applicant's character and capacity. There are no formulas, however, for analyzing these two most important points. The bank takes into consideration all the factors upon which success in business ultimately rests. Personality, standing in the business and social community, attitude toward obligations,

ability as a manager, relations with employees—all of these are considered. This information is obtained from the inquiries made among the applicant's business associates and from personal interviews with the borrower.

Financial Statement of the Applicant.—To form an estimate of the financial standing of the applicant, the bank relies almost exclusively upon the financial statement. Banks usually prefer to receive from customers audited statements—a preference not due so much to the fact that the bank questions the honesty of its customers, but rather because the audited statement presents credit information in a uniform and readily comprehensible manner. The statement submitted consists of a balance sheet and a profit and loss statement covering operations for a definite period. In order to compare the statement of one period with that of another, the information embodied in them is drawn off on a comparative statement (Form 23).

Balance Sheet—Quick Assets.—The balance sheet is examined first to observe the value of the quick assets. These include such items as cash, accounts receivable, merchandise, raw materials, and any other valuable possessions which will be liquidated in the regular course of business in the near future. The quick assets are separated from the fixed assets, which consist of real estate, plant, and machinery. The liabilities are also separated into current and fixed liabilities. The first class consists of such items as notes and accounts payable, which must be paid off in the near future. Fixed liabilities consist of long-term bonds and mortgages which have been issued to cover certain of the fixed assets. The balance sheet also shows the net capital of the concern.

Cash Account.—The cash account is examined to ascertain whether it includes such items as demand notes or I. O. U.'s covering withdrawals, expenses or loans to members or employees

COMPARATIVE STATEMENT

Name THE JOHN DOE MANUFACTURING COMPANY, **Endorser**

Address NEW YORK CITY **Brokers**

Business Manufacturers of Felt Hats **Accounts** Metropolitan Trust Company) N. Y. C.
Centennial National Bank)

Information received from	Key	-F. R. Form-	Key	Direct-Unsgd	Key		Key		Key	
Date		Oct. 31 1920		Jan. 31, 1921						
Current Assets:										
Cash		37 917		88 922						
Accounts Receivable—(Merchandise)	A	278 964	*KA	507 912						
Notes Receivable—(Merchandise)	A	300								
Trade Acceptances Receivable	A	2 321	*KA							
Drafts against Foreign Shipments										
Merchandise—Finished	J	85 907	G	16 815						
Merchandise—Unfinished	)		)							
Raw Material	)J	455 845	G	807 400						
U. S. Liberty Bonds										
War Certificates		866		872						
Total		856 120		1 521 921						
Fixed Assets: Tenement Bldgs.&R E.				10 886						
Real Estate		30 000		20 000						
Buildings	)B	137 425	)B	145 245						
Machinery, Fixtures and Equipment	)		)							
Good-will, Patents, etc.	*	249 000	*	249 000						
Due from Officers, Employees, etc.										
Investments in Affiliated Companies		125 583	L	10 000						
Other Stocks, Bonds, etc.			M	100						
Deferred Charges		10 242		12 255						
Advances to Dobbs & Company			N	128 212						
Total		542 250		575 698						
Total Assets		1 398 370		2 097 619						
Current Liabilities										
Accounts Payable		37 958		330 803						
Notes Payable to Own Banks		275 000		525 000						
Notes Payable through Brokers										
Notes Payable for Merchandise										
Notes Payable to Others				59 815						
Trade Acceptances Payable				12 224						
Due Banks or Bankers for Foreign Credits										
Reserve for Taxes		102 703	O	114 492						
Dividends Payable										
Labor and Salaries a/c-Not due		64 569	P	74 258						
Total		480 230		1 116 592						
Deferred Liabilities:										
Bonded Debt (due)										
Mortgages and Liens (due)										
Total		none		none						
Capital Issued: Preferred		250 000	I	250 000						
Common		233 500	IC	333 500						
Surplus and Undivided Profits		434 640		497 527						
Total Liabilities		1 398 370		2 097 619						
Selling Terms	6/10,	5/30-30 x								
Annual Sales		2 279 119								
Net Profits		160 457								
Dividends Paid		25 000								
Withdrawals by Partners										
Outside Means of Endorsers										
Insurance Fire on Buildings	)	Blanket								
Machinery, Fixt. and Equip.	)	300 000								
Fire on Merchandise	)									
Life		50 000								
Recapitulation:										
Total Current Assets		856 120		1 521 921						
Total Current Liabilities		480 230		1 116 592						
Net		375 890		405 329						
Ratio		1.78		1.36						
Total Assets		1 398 370		2 097 619						
Total Liabilities (ex. Capital, Surplus and Undivided Profit)		480 230		1 116 592						
Net	*	918 140	*	981 027						
Contingent Liabilities		none								
Current Liabilities-Maximum	8-31--	842 732								
Current Liabilities-Minimum	2-29--	124 878								

Form 23 (a). Comparative Statement of a Corporation (face). (Size 9 x 16½.)

of the concern. The practice of carrying such items in the cash account is regarded unfavorably by the bank. The bank wishes to know whether the cash is readily available for the needs of the

KEY		
A—Reserve for Doubtful Receivables deducted as follows:		
Accounts Receivable	8 275)	
Notes Receivable	not)*	35 916
Trade Acceptances	not)	
B—Reserve for Depreciation deducted as follows:		
Buildings	44 731)	
Machinery and Fixtures	165 511)	217 028
C—Treasury Stock deducted as follows:		
Common		16 500
D—No reserve reported.		
E—Cost		
F—Market		
G—Basis of valuation not stated.		
H—Further information desired.		
I—Capital Authorized:		
Preferred. 8% Cumulative		250 000
Common.		250 000

J-Valued at cost or market, whichever is lower.	
K-Trade Acceptances Receivable	27,331
Accounts Receivable	616,497
Total Receivables	643,828
Less-Reserve	* 35,916
	607,912
L-Capital stock investment in Dobbs & Company	
M-25 shares G. J. Mathis Company preferred stock.	
N-Includes U. S. Government Bonds loaned them in amount of	30,000
O-Reserve for State and Miscellaneous Taxes	1,432
Reserve for Inc. & Excess Profits Taxes-1919	76,060
Reserve for Inc. & Excess Profits Taxes-1920	37,000
	114,492
P-Including an unspecified amount of local taxes.	

Form 23 (b). Comparative Statement of a Corporation (reverse).

business; whether it is tied up on deposit with concerns in the process of liquidation; whether a large sum of cash has been accumulated for definite expenditures in the near future such as the distribution of dividends or the payment of salaries.

Notes Receivable.—The item of notes receivable is scrutinized to ascertain whether it includes only strictly trade notes given for

actual purchases, or loans to officers and employees, subscriptions for stock, accommodation notes and notes of affiliated concerns, or hypothecated notes. Many of these types of notes receivable would be uncollectible in case of failure. The volume of the notes receivable is considered in the light of the custom prevailing in the applicant's particular line of business. If, for example, it is customary to take a buyer's notes, the notes receivable account may be large. In general, however, an extraordinarily large volume of notes receivable would be regarded as an unfavorable indication. The length of time the notes have to run is also considered. Long-term notes are less desirable for an active business concern than short-term notes.

Accounts Receivable.—The item of accounts receivable is analyzed to determine the amount or proportion of the accounts receivable due from affiliated concerns or from persons who are closely associated with the business. Effort is made also to learn whether any of the accounts receivable have been hypothecated. The use of accounts receivable as security for loans is a sign of weakness, for it indicates that the applicant has been hard pressed to secure credit. In addition a bank desires to know whether the accounts receivable can be readily liquidated. Thus, if the majority of these accounts have grown out of transactions recently effected and if there are very few long-standing accounts or past-due accounts, the indication is that the accounts of the firm are highly liquid and that it has an effective collection system. Concerns which adopt a policy of charging off bad accounts and of setting up a reserve for those which may prove uncollectible in the future, enjoy a better rating than those which do not pursue this cautious policy.

The Inventory.—Another item which receives careful consideration in analyzing the credit statement is the inventory. The bank desires to know the basis that has been used in arriving

at the figures given, whether the inventory is figured at cost or at market price, and which price was the lower at the time of taking stock. It is a healthy sign, from the viewpoint of the credit man, to see old goods eliminated from the live assets of a concern either by charging off the proper depreciation or by closing them out through special sales. A concern which lists its goods on hand at prices above the current market level would be subject to the suspicion of padding its statement, and would therefore not be regarded as a good credit risk. The inventory is also considered in the light of the kinds of goods which it includes. More allowance for depreciation must be made for luxuries, novelties, and seasonable goods than for staples.

Stocks and Bonds.—Another item considered in the analysis is that of stocks and bonds. The appearance of this item among the assets may indicate a speculative tendency in the business which would be undesirable; on the other hand, it may indicate an investment of surplus funds in readily salable securities, thus strengthening the credit standing of the applicant. Stocks and bonds of affiliated or subsidiary concerns are not regarded as particularly good assets upon which to base application for credit. In such case the bank ascertains the relationship existing between the two concerns. The one may have contingent liabilities or contractual relations with the other which are incurred in the ownership of such securities.

Real Estate.—In considering the item of real estate, effort is made to determine whether mortgages are outstanding against such property; whether the buildings and plant are in good operating condition and well adapted for the business; whether a sufficient amount of insurance is carried; whether there are any unpaid taxes, any assessments or other liens outstanding against it; and whether the site and buildings are adapted for other than the present uses. Here also the policy of the applicant toward de-

preciation is considered. Attention to this factor is particularly important where there is a heavy investment in machinery.

Sundry Assets.—Among the sundry assets found in a financial statement, the credit man of the bank considers insurance and other deferred charges as having weight from a credit point of view if they represent actual unexpired values. Good-will, patents, trade-marks, leaseholds, and such items are of varying value, and there is a growing tendency to eliminate them from balance sheets or at least to carry them at merely nominal value. The power of self-liquidation within a reasonable time is the most important consideration in connection with the assets of an applicant.

Current Assets and Current Liabilities—Relation.—Business concerns get into difficulty most frequently because their current assets are not sufficiently large to take care of their current liabilities. Hence the credit man of the bank desires to know on the one hand the amount of quick assets, and on the other the volume of current liabilities. Of the latter, notes payable represent the most important item. Generally speaking, the volume of notes payable ought to be small, except in those lines of business where it is customary to purchase mainly on the basis of notes rather than on open accounts. If notes are given for overdue accounts it is considered a poor recommendation for the applicant.

The amount of notes given by the applicant to banks for borrowed money, and the total amount outstanding, are important considerations. Notes payable which represent loans or advances from officers, directors, or other persons closely associated with the applicant may indicate additional security, inasmuch as it is evidence that those interested in the business are willing to risk their money in it. On the other hand, there is the possibility in such case that these borrowings have been made because no other source of credit could be found. These persons

may have been willing to invest their money because of the confidence that advance information in case of financial trouble would enable them to recover their funds before other creditors.

Appraisal of Financial Judgment of the Applicant.—The use which the subject makes of borrowed funds is also important to know. Funds borrowed from a bank are wisely used in settling open accounts—thus obtaining discounts on purchases—and for manufacturing or operating outlays. It is poor policy to borrow on short-term loans for the purpose of adding to slow assets or for paying dividends. In considering the item of accounts payable, the bank desires to know what amount is represented by trade obligations, what amounts are past due, if any, and what amounts are secured in some manner. It is also important to know the amount due to affiliated concerns, officers, directors, employees, or others closely associated with the business.

Fixed and Contingent Liabilities.—The fixed liabilities include generally bonded indebtedness. In analyzing credit information the bank is interested to note whether the bonds are amply secured by mortgages. If they are not, they constitute a lien upon the general assets of the concern, and in the event of liquidation the unpaid residue would share equally with the claims of other creditors. It is also important to note the amount of bonds authorized, the total amount issued, and the purpose for which the issue is made. In addition, the provisions for retirement of the bonds and the extent to which the applicant is meeting the sinking fund requirements are scrutinized.

The credit man is particularly desirous of knowing that all assets and particularly all liabilities have been indicated on the statement. Contingent liabilities, such as notes receivable, discounted accommodation notes, indorsed notes, and similar items which do not always appear on the financial statement, are frequently the cause of failure.

Analysis of Profit and Loss Statement.—In analyzing the profit and loss statement the bank is interested in knowing whether the net profits are commensurate with the volume of business and the amount of capital employed. The policy of paying dividends from any funds excepting the profits of the current period or a comparatively large surplus, is considered derogatory to the credit rating of the applicant. Sales and profits for the period under consideration are compared with those for the corresponding periods during past years, for the purpose of determining whether the concern is making progress. Finally, the attitude on the part of the applicant toward the accumulation of a surplus to provide working capital aids in determining whether conditions are favorable for granting credit.

General Significance of the Statement.—The last phase of the analysis of credit information is the consideration of the general appearance of the statement. If the statement is complete and clear in every detail—that is, if it brings unfavorable points into equal prominence with favorable ones—it is worth more from a credit point of view than a garbled or ambiguous report which seeks to gloss over unfavorable features. If the applicant gives evidence of a willingness to coöperate in every possible way in presenting a clear and complete view of his financial standing, the bank will rate him higher as a credit risk than if he furnishes information sparingly and reluctantly.

3. Furnishing Credit Information to Others.—Besides obtaining and analyzing credit information for its own purposes, the credit department of a large bank also performs the function of disseminating credit information. This is a very important part of the service which the bank renders. Credit men, both in banks and in other concerns, rely to a very considerable extent upon the service of the metropolitan banks for information concerning those to whom they propose to extend credit. This service is

becoming increasingly important in connection with foreign trade. American manufacturers desiring to transact business with foreign concerns, and foreign manufacturers wishing to deal with American traders, look to the credit departments of the large banks for information without which it would be practically impossible to extend their foreign connections. This information is furnished in writing and by personal interviews, care being taken to make sure that it will be held confidential.

Additional Services.—Banks located in the smaller towns or cities frequently call upon their city correspondents to purchase commercial paper for them as an investment of their surplus funds. The metropolitan banks perform this service usually without charge, merely as a matter of accommodation to the interior bank. In order to give the most satisfactory service, they must know the credit standing of the persons whose paper they purchase for the account of the interior bank. Still another service of the credit department is that of advising and assisting customers who desire to improve their credit standing. The wide experience of the credit men in a large bank makes it possible for them to give expert advice in this matter. Finally, the credit department performs an important service by coöperating in obtaining new business for the bank. The desirability of investigating carefully a prospective customer before he is approached by the bank's solicitors, is self-evident. Frequently those who solicit new accounts consult the credit department for an estimate of the standing of the prospective customer before making any effort to secure his business. If the report is unsatisfactory he is not approached; if it is satisfactory effort is made to secure him as a depositor.

The Line of Credit.—After the credit information has been gathered and analyzed, the bank officers decide upon the advisability of extending credit to the applicant. The decision of the

officers is subject to approval by the board of directors. If the decision is favorable a line of credit is granted to the customer, or a loan agreement is entered into. A line of credit is an agreement on the part of the bank to carry loans for the beneficiary up to a certain maximum at any one time. This line of credit is subject to revision at intervals, but while it is in force the bank makes every effort to provide the funds, so long as the credit standing of the applicant undergoes no important change. The customer's application for the line of credit is placed on file, and on it is noted the amount then owed to the bank on account of loans, discounts, and commercial credits; the amount and maturity of his last loan; the amount borrowed during the previous year; and at what time and for how long he remained out of debt to the bank. Record is also made of the customer's average balance, the balance at date of application, and the rate of interest, if any, allowed the applicant on average balance.

Stipulations Regarding a Line of Credit.—When a line of credit is granted, certain stipulations are made with regard to indorsers, collateral, and the amount of the average balance which the borrower must keep on deposit with the bank. It is usually stipulated that the borrower must be entirely out of debt to the bank at some period during the year. Each application for a loan under a line of credit is examined with almost as much thoroughness as is his credit standing at the time of granting the line of credit. This investigation is for the purpose of ascertaining whether any important change has occurred in the credit position of the applicant.

If collateral is deposited as partial security for the loan, it is examined by the credit department. Notes deposited as collateral are examined to see that they are in propér form; that the amounts in figures and in writing correspond; that the notes are not out of proportion to the credit rating given the makers; that datings are correct; that the notes mature within a reasonable

time and are signed properly; that they are negotiable and are properly indorsed. Other forms of collateral, such as stocks, bonds, warrants, and warehouse receipts, are examined to see that they are properly drawn and assigned. When warehouse receipts are used, an investigation of the standing of the warehouse company signing the receipt is made, and certification is obtained as to the grades, weights, and nature of the commodities offered. If the line of credit agreement requires that the borrower furnish indorsements as guarantees, the credit department sees that such indorsements are obtained.

CHAPTER XVII

LOANS AND DISCOUNTS

Similarity of Loans and Discounts.—In the published bank statement loans and discounts are usually combined in a single item, the largest item among the assets. Loans and discounts are similar in that they represent an advance of funds, in the form of bank credit, made with the understanding that the money advanced will be paid to the bank at some definite time in the future. It goes without saying also, that the bank in each case expects to be recompensed for its service in advancing the funds. There are, however, certain marked differences between loans and discounts.

The Financing of Deferred Payments.—Before discussing in detail the differences between loans and discounts, the practice in both of these types of transactions may be considered in general terms. Suppose a merchant in Galveston buys a quantity of flour from a miller in Minneapolis. The miller desires his money immediately, but the Galveston merchant has not the money at hand with which to pay him. There is no doubt that the merchant will be able to sell the flour, and that after he has done so he will have sufficient funds not only to settle his account with the miller, but to leave something remaining as his own profit. The problem is to find some means by which the miller may get his money immediately, some means by which the merchant may have the money to pay the miller before the flour is sold. Leaving out of consideration the fact that the miller might sell on credit and might then borrow from a Minneapolis bank on his own note, there are two ways of meeting this problem.

The Galveston merchant might go to his local bank and

arrange for an extension of credit. He would give a note, properly secured, agreeing to repay the bank within a definite time, say 90 days. He would receive credit for the money in his deposit account with the bank, and would send his check or a bank draft to the miller. Or he might draw a note, made payable to the miller, for the full amount due and send the instrument to Minneapolis. The note represents a promise on the part of the Galveston man to pay the Minneapolis man the specified sum at a definite time. But the Minneapolis miller has not yet obtained his money. He indorses the note which he has received from his customer, and then presents it to his bank in Minneapolis as a piece of property having a value at maturity equal to the amount specified on the face, and this he requests the bank to buy. The bank knows the miller and is satisfied that he is responsible, in other words, that if the note is not paid by the signer at maturity the bank will be reimbursed by the miller.

Theory of the Discount.—Assuming that the bank is satisfied and buys the note, there remains the determination of the price to be paid for it. If the amount of the note is $5,000 the bank will say in effect: "This is worth $5,000 but only on condition that we hold it to the date of maturity, say 90 days. If we buy it now for the value it will have in three months, we will lose interest on the money, since if we did not buy it we could lend the $5,000 to someone and collect, say 6 per cent interest." The price which the bank will pay, therefore, will be determined by the length of time the note has to run before payment and the current rate of interest for bank loans. In the case assumed, the bank would calculate that 6 per cent interest on $5,000 for 90 days would be $75, and it would therefore agree to buy the $5,000 note for $4,925. The miller would thus obtain, in exchange for the Galveston merchant's promise to pay him $5,000 in 90 days, $4,925 in cash without waiting. The bank would give up $4,925 in cash and would receive $5,000 in 90 days.

Trade Acceptances a New Form of Discount.—Since the establishment of the federal reserve system, a variation in such methods of settlement as the foregoing is becoming popular. Purchases and sales are frequently financed by means of trade acceptances. Although this method of payment is in essence the same as the discounting process just described, the procedure would be somewhat different, perhaps as follows: The Minneapolis miller may send, through his bank to the Galveston bank, a draft on the Galveston merchant for $5,000 payable 90 days after sight and attach to such a draft the bill of lading and other shipping documents, with the request that these be given up only when the local merchant has accepted the draft. The merchant accepts the draft by writing his name across the face, with the date on which the acceptance was made. The draft then becomes virtually a promissory note. The shipping receipts are delivered to the merchant and he gets the flour. He now has 90 days in which to dispose of the shipment, and from this sale it is presumed that he will derive more than enough income to be able to pay the draft at maturity. In the meantime the accepted draft will be returned to the miller, who may take it to his Minneapolis bank with the request that the bank purchase it, or discount it in the same manner as it would in the case of a promissory note.

Loans and Discounts Contrasted.—The distinction between loans and discounts, as stated in broad terms in the first paragraph of this chapter, may be brought out more clearly by placing the characteristics of the two forms of credit extension in parallel columns.

LOAN	DISCOUNT
Contract or agreement between bank and customer under which funds are advanced, to be repaid according to terms of the contract.	A purchase; the claim of the person to whom the note is payable is transferred to the bank.

Loan	Discount
Interest is payable at the maturity of the loan, or at stated intervals after the loan is made.	Interest is deducted in advance, i.e., when the note is sold to the bank.
Payment frequently guaranteed by deposit of collateral.	Not usually secured by collateral.
Sometimes indefinite, e.g., a demand or call loan which is payable at any time the bank demands it, also at any time the borrower may desire to pay it off.	Definite date of maturity; this must be the case or the bank would have no way of determining the price to pay for the note.
May arise from many transactions, e.g., erection of buildings, buying land, stocks, bonds, or other commodities.	Usually grows out of purchase and sale of commodities.
Usually signed by one person or corporation—one-name paper.	May be two-name paper, i.e., signed by one person and indorsed by another, either one of whom or both are responsible to the bank for payment.
Preparation for payment not implied on face of the note.	Note itself usually indicates purpose of borrowing and suggests its self-liquidating nature.
Rate of interest must be specified, for the principal advanced is identical with the face value.	No rate of interest specified. Difference between the amount advanced and the face value is the interest.

The above lines of distinction are not always clearly drawn. Credit advances which are essentially loans are sometimes treated as if they were discounts, the bank deducting the interest in advance and paying to the borrower only the proceeds.

Relation of Deposits to Loans and Discounts.—The intimate relation between a bank's advances of credit and its deposits has been pointed out. In the case of both loans and discounts, when funds are advanced to a customer by a bank, they are given

usually in the form of a credit to his account. He is then able to use them for payments just as effectively as though they were actual money, and much more conveniently.

Loans Classified.—The various kinds of loans made by a modern commercial bank may be classified, according to the security pledged, in four main groups: (1) loans secured by stocks and bonds, (2) merchandise loans, (3) loans based upon receivables, and (4) loans made upon arrival drafts.

1. **Loans Secured by Stocks and Bonds.**—The advances based upon pledges of stocks and bonds may be subdivided into two classes: stock exchange loans, and non-stock exchange loans. Stock exchange loans are made only to members of the stock exchange and are usually made only on the security of stocks and bonds salable on the exchange. Non-stock exchange loans may be made to persons who are not members of the exchange, and may be based on the deposit of any acceptable stocks or bonds.

2. **Merchandise Loans.**—Merchandise loans are those made upon the security of warehouse receipts, bills of lading, and similar evidences of ownership of merchandise. They are negotiated most frequently in connection with financing the manufacture and marketing of staples such as wheat, cotton, and meat. The handling of this type of loan has been so perfected that by changing the collateral successively from bills of lading to trust receipts, and from these to warehouse receipts, it often happens that practically the same loan covers the progress of the raw material from the primary market through the mill and into the retail store, payment of the loan being finally made from the proceeds of sales to retail buyers.

3. **Loans Based on Receivables.**—Loans made upon receivables are advances, the collateral security for which consists of

notes receivable deposited by the borrower. Such loans are usually payable on demand.

4. **Advances Upon Arrival Drafts.**—Advances made upon arrival drafts consist of loans made upon the security of drafts to which are attached bills of lading. These are generally short-time advances, made to a shipper of merchandise to bridge the interval of time during which goods are in transit. Two forms of such loans are worthy of particular note. One of these is represented by loans made in connection with the shipment of goods to a particular point, say New York City. A draft is drawn payable upon the arrival of the goods at destination, and the shipping documents giving possession of the goods are delivered only upon payment of the draft. A considerable interval might elapse from the time of the shipment of the goods until their arrival, during which period the shipper would be unable to get his money. The draft, however, is forwarded to a New York bank and the bank presents it to the consignee, obtaining his assurance that payment will be made upon the arrival of the goods. On the strength of this promise, supported by a lien upon the shipment which is afforded by the shipping documents and by the credit rating of the shipper, the bank advances funds to the latter, charging him at the current rate of interest and reimbursing itself for the amount of the loan when it has collected the draft.

A second important type of the loan based upon arrival drafts is one in which a bank in one city, for instance, New York, advances funds for shipments of goods between two other cities. The shipper in such a case draws a draft to which are attached the shipping documents in the usual way, and delivers them to the New York bank which is to make the loan. As the goods are not to come to the city in which the loan is made, they do not come into the actual possession of the lending bank. The lending bank, however, has the documents which give the right of possession of the goods. These are sent with the draft to a correspondent bank

in the city to which the goods have been shipped. When the goods arrive and the draft is paid by the consignee, the funds are forwarded to the lending bank by the correspondent. The lending bank then reimburses itself for the funds advanced and, after deducting the interest, places whatever balance there may be to the credit of the borrower.

Demand Loans.—Loans may be classified according to their duration, as either demand loans or time loans. Demand loans, as the name signifies, are payable at the option either of the borrower or lender, the most frequent form being the demand street loan, or call loan. Such loans are made strictly in accordance with the usages of the New York Stock Exchange. They are negotiated through money brokers who are members of the exchange, and are secured by collateral consisting of stock exchange securities. Frequently, however, demand loans are made which are based upon stocks and bonds other than those dealt in on the New York Exchange, and at times such loans are negotiated with warehouse receipts or bills of lading as collateral.

Time Loans.—Time loans are advances made for a definite period and at a fixed rate of interest. The period varies from one day to six months, although the usual period is 30, 60, or 90 days. The one-day loan, or clearance loan, is found chiefly in New York. This is strictly a stock exchange loan. Brokers place with their banks certain approved stocks and bonds. If during the course of the day such brokers should need more funds than they have on deposit, arrangement is made to advance a sufficient amount on the basis of these stocks and bonds as security. At the close of the day additional funds are deposited as the result of the day's transactions and the day, or clearance loan is closed. Inasmuch as such loans do not run for a full day, no interest is charged. The longer term loans are sometimes made to stock exchange members on the basis of stocks and bonds as collateral; or they may be

made to other borrowers on merchandise security, or on any other security or credit which the lender is willing to accept.

Preferences as to Collateral.—In making loans upon collateral securities, banks prefer those securities which are listed on the stock exchange. There are definite reasons for this preference. Listing is a condition precedent to salability on the exchange. This is important in case the bank should find it necessary to sell the collateral for its own protection. Listing on the exchange gives the bank assurance of the validity of securities, inasmuch as they are not so listed until the listing committee of the exchange is convinced that they are valid. Furthermore, corporations whose securities are listed on the stock exchange are required to submit periodical reports and statements of financial condition for publication by the exchange.

In addition to preferring listed securities, banks ordinarily prefer those which are dealt in frequently, rather than those which change hands rarely. The bank is able to obtain a more recent consensus of opinion as to the value of active securities, and can feel reasonably certain that they can be readily disposed of in the market in case of necessity.

Rails versus Industrials.—Banks also express preference as to the proportions of different kinds of securities which are accepted as collateral for a given loan. Most stock exchange loans are made upon security consisting in part of railroad stocks and bonds and in part of industrial stocks and bonds. The first are spoken of as rails and the second as industrials. While there is considerable variation as to the relative proportion of these two groups which are accepted by different banks, in general the preference has hitherto been given to rails; the rails have had greater stability as well as a wider market and therefore could be more readily marketed without loss. Sometimes the division is made on the basis of 50 per cent of each group; at other times 60 and 40 per

cent, or 75 and 25 per cent, are the proportions approved. Where loans are made on collateral that is wholly industrial, the banks making such loans sometimes charge a higher rate of interest and demand a larger margin.

Margin Requirements.—The margin, as the term is used in this connection, is the excess of the market price of the collateral over the face of the loan. It is expressed in a percentage of excess of market value over the face value. The margin naturally varies with different types of collateral and with different banks, as well as with varying business conditions. Thus, when business conditions seem very unsettled, a larger margin may be required than under conditions of greater stability. As was said previously, stocks which fluctuate widely or whose earnings are less stable, must be put up in larger proportion to secure loans than stocks which fluctuate less rapidly. The usual margin on call loans is 20 per cent. For time loans the margin varies with the length of time the loans have to run, as well as with the nature of the security. In making loans secured by United States government bonds the margin is sometimes as low as 10 per cent.

Variety and Size of Blocks.—Another point about which banks have certain preferences is the number of different security issues which make up the collateral. The greater the variety of securities presented, the smaller is the risk, although too many issues may indicate blocks too small to be readily disposed of on the exchange.

Collateral Must be Negotiable.—Finally, no collateral will be accepted by a bank unless it is in negotiable form so that it can be sold in case of default by the borrower. As is pointed out elsewhere in this volume, securities are transferred from one owner to the other by assignment on the books of the issuing corporation. The borrower, therefore, must give the bank either an assignment in blank or a power of attorney, empowering it to

transfer ownership of the securities in case it becomes necessary to sell them. The stock exchange has established rules for what is called "good delivery," and banks insist that the collateral must be in such form as to comply with these rules. The rules cover the kinds of stocks and bonds which may be sold, the units in which they can be sold, the method of executing assignments and powers of attorney, and they also designate the legal qualifications which a person, firm, or corporation must have in order to make proper transfers.

Bank Stocks as Collateral.—Unlisted stocks and bonds are sometimes accepted as collateral, the requirements as to the margins, proportions, and assignments being determined by each bank for itself. Where the securities are not traded in on any exchange, the bank must have recourse to whatever sources are available to ascertain the probable market value of such securities. Bank stocks illustrate a form of security which is frequently used in this manner.

Warehouse Receipts and Bills of Lading as Collateral.—Another form of collateral which is extremely important in protecting the loans of the modern bank is that upon which merchandise loans are based. The collateral takes the form chiefly of warehouse receipts and bills of lading. The lending bank must exercise care to see that the warehouse receipts and bills of lading, which purport to evidence that the merchandise is in the hands of the warehouse or transportation company, are genuine and have been properly executed. Lenders can determine these points with more certainty since uniform warehouse receipts acts and uniform bills of lading acts have been adopted by several states. The Pomerene Bills of Lading Act passed by Congress in 1916 also has contributed much toward establishing uniformity in bills of lading, and thereby toward eliminating uncertainties in estimating the value of such instruments.

It is not only necessary to know that the warehouse receipts

and bills of lading are in proper form, but the lender must know also the condition of the merchandise covered by such instruments. Hence there are needed a certification of weight and grade and an appraisal of the goods, which documents must have been prepared by public officials or by the properly designated officials of commodity exchanges.

Warehouse Insurance.—Another risk that must be guarded against is the risk of the destruction of the warehouse itself. Usually the lender insists upon having insurance policies or certificates to cover any loss which might result from the destruction of the property. If the property is in transit on a railroad, the transportation company is legally the insurer of the goods. There are certain other risks, however, attached to bills of lading. For example, a bill of lading does not guarantee the kind of the goods which it covers and in many instances it is stamped "Shipper's load and count," or "Packages said to contain" a certain quantity. There is always a possibility that partial delivery may have been made on the bill of lading without indorsement indicating such delivery on the instrument. In such cases the value of the bill of lading as collateral would depend entirely upon the credit standing of the borrower.

Approved Warehouses.—The reliability of warehousemen is an important factor in determining the value of a warehouse receipt as collateral. Each commodity exchange approves certain warehouses in its vicinity by designating receipts issued by such warehouses as suitable instruments to be passed from buyer to seller as good delivery of the merchandise represented. If the receipt is one issued by a warehouse that has such approval, banks will more readily accept it as collateral for a loan.

Other Forms of Collateral—Real Estate Mortgage.—The kind of collateral that is accepted most frequently by banks as a basis

for loans varies somewhat in the different sections of the country. In New York, corporate securities and warehouse receipts represent a large portion of the collateral, whereas in the Middle West and South mortgages on farm lands and warehouse receipts based on agricultural products are found most frequently.

New York, April 15 1921

Received, from THE NATIONAL CITY BANK OF NEW YORK, the following property, held by the Bank as collateral security:
100 bags coffee covered by Bills of Lading
Car No. 12466 New York Central R.R.

and in consideration thereof we HEREBY AGREE TO HOLD SAID PROPERTY IN TRUST for the following purposes, viz: transfer to warehouse

and we will return the said property, or as soon as the merchandise can be stored in the warehouse & proper receipt issued with due diligence to the Bank, the intention of this arrangement being to protect and preserve unimpaired the lien of THE NATIONAL CITY BANK OF NEW YORK on said property.

Johnson & Brown
By - J. F. Johnson
Treasurer.

Form 24. Trust Receipt. (Size 7¾ x 5½.)

When a bank accepts a mortgage on real estate as collateral, the borrower transfers ownership in the property to the lender with the proviso that this transfer shall be void if the borrower meets his obligation, that is, pays interest and principal at specified times. Real estate is generally accepted as collateral at not more than 60 per cent of the appraised value of the property, and in many cases at not more than 50 per cent of its appraised value. There is among many bankers a prejudice against real estate loans, growing out of the fact that such property is frequently hard to dispose of in case of necessity. Since banks are required

to meet their obligations in large measure upon demand, the feeling is that they cannot afford to tie up a large part of their funds in sluggish security. For this reason, there was for many years a prohibition in the National Banking Act against accepting real estate as security for loans. Since the passage of the Federal Reserve Act, national banks not located in central reserve cities are, however, permitted to make loans secured by real estate if such loans do not exceed 50 per cent of the appraised value of the property. Certain other restrictions as to the duration of the loan and the total amount that may be loaned in this manner are still in effect against national banks. The regulations as to such loans by state banks vary with the different states.

Trust Receipts, Chattel Mortgages, and Life Insurance Policies.—Another form of collateral is the trust receipt based on various commodities. A trust receipt (Form 24) is a legal instrument which guarantees that certain specified property covered by the receipt will be kept subject to the orders of the lender until the borrower has complied with the terms of an agreement. Under certain circumstances banks may safely loan on these, because if the borrower fails to meet his obligations as agreed, the goods covered by the trust receipt become the property of the bank.

Still other forms of collateral sometimes used are chattel mortgages based upon live stock, farm implements, household furniture, and similar property. Even life insurance policies are sometimes offered and accepted as collateral for a loan. These furnish satisfactory collateral, provided they have a cash surrender value in excess of the loan and are accompanied by an assignment of the policy properly recorded with the insurance company.

CHAPTER XVIII

LOANS AND DISCOUNTS (CONTINUED)

Unsecured Discounts.—In contrast with loans secured by collateral, there are discounts which are unsecured, though the fact that they are unsecured must not be interpreted to indicate that they are unsafe. As a matter of fact many bankers regard commercial discounts as the safest and most liquid form of loan. Their safety is assured by the facts that all the assets of the two persons whose names usually appear on the notes may be levied upon for payment if necessary; that the loan is negotiated for the purpose of facilitating the movement of goods actually in process of going to market; and that by the time the note is payable the commodities will have been sold and the money will be actually in hand if the borrower desires to pay.

The chief risk attached to the discounting of commercial paper is largely dependent upon the question as to whether the borrower may be able and willing to pay. This risk is minimized by the investigations conducted by the credit department of the bank. The *raison d'être* of the credit department is to furnish such information as will enable the bank to make its advances to customers with a minimum of risk.

Discounting an Aid in Marketing Products.—The discounting of commercial paper is one of the most important economic functions of the commercial bank, in that its purpose is to bridge the gap between the various processes of production and sale. Between the beginning of the manufacture of goods and the time when they are actually in the hands of the consumers and are paid for by them, there may be a span of months or even years, Consumers will not pay in advance for the manufacture of the

goods they want, and producers cannot wait for months or years to be paid for their work. To bridge this gap is the commercial bank's function in the economic scheme. The bank meets the needs of both producers and consumers chiefly by the process of discounting the claims for future payments which producers hold against the consuming public.

Cash Discounts.—The discounting process, however, does not always result in the use of advances as described above, which are technically spoken of as bank discounts. One of the most common methods of handling purchases and sales is for the seller to dispose of his goods on credit, the terms varying from, say, 10 to 90 days. The purchaser is generally given the privilege of discounting his bill, that is, deducting therefrom an agreed per cent, if payment is made within a specified period, say 10 days. Such discounts are known as cash discounts and they range from ½ per cent to 5 or 6 per cent or even more. Goods sold in this way are said to be sold on open book account terms and such business gives rise to another form of borrowing.

Buyers do not always take advantage of the cash discount terms offered by sellers, and accordingly the financial burden has to be assumed by the seller until such time as the obligations of the buyers mature and are paid. Sellers usually finance a transaction of this sort by borrowing at their banks, most frequently upon their unsecured notes, in an amount sufficient to carry their open book accounts for the season. When it is considered desirable to take advantage of cash discounts, buyers frequently obtain the funds with which to settle their accounts by borrowing on their secured notes from their banks. Such notes, whether of buyer or seller, give rise to the second form of bank loan previously mentioned (see page 277).

Borrowing Against Receivables and Acceptances.—Another method of financing the production and sale of goods is by the

use of what are called receivables. In some trades it is customary for the buyer to give promissory notes in settlement of his purchases. These are time obligations and have to be carried just as do open book accounts. The seller in such case usually finances the transaction by borrowing from his bank upon his unsecured promissory note, as described above, an amount sufficient to enable him to carry his notes receivable until their maturity. Occasionally the seller discounts the receivables themselves at his bank in order to obtain funds to finance his future operations.

The use of trade acceptances affords still another means of financing business transactions. The purchaser accepts a time draft for the amount involved and this draft, after acceptance, has the same status as a promissory note or a receivable. The owner of the trade acceptance either discounts it at his bank or borrows upon his own unsecured note an amount sufficient to enable him to carry the acceptance in his portfolio until its maturity.

Borrowing in the Open Market.—It has been assumed that the borrower, whether he be the buyer or seller, goes directly to his bank for the advance he requires. Frequently, however, concerns finance their transactions by selling large blocks of notes in round denominations through note-brokers. The note-brokers act as middlemen, purchasing the notes of these large borrowers and selling them to banks or other financial institutions having funds awaiting temporary investment. This method of financing business is termed borrowing in the open market.

Commercial Paper Defined and Its Advantages.—The notes which are used in connection with the transactions just described are spoken of as commercial paper. Commercial paper has been defined by the Federal Reserve Act and by the rulings of the Federal Reserve Board in regard to rediscounts in substance as follows:

To be classed as commercial paper the instrument must be a note, draft, or bill of exchange growing out of an actual commercial transaction, that is, it must have been issued or drawn for agricultural, industrial, or commercial purposes. Loans negotiated or notes drawn for the purpose of carrying on trading in stocks, bonds, or other investment securities—except bonds of the United States government—are excluded. Such paper must run for not more than 90 days except in the case of paper arising from agricultural transactions, which may have a maturity of not more than six months. Furthermore, the notes must be self-liquidating, that is, they must have been drawn for the purpose of moving commodities to the market, and since the paper is not renewable at the end of the period, it is assumed that the sale of the commodities will provide the funds for liquidating the notes. Such paper possesses advantages from the point of view of the borrower and the bank alike.

The advantage from the borrower's point of view is that he can buy goods for the purpose of reselling them and need not pay for them until he has sold them. Furthermore, he does not need to put up any of his property as security for the loan. From the standpoint of the bank, the advantages are that if the credit risk has been carefully scrutinized in advance the loan is as certain of repayment at maturity as anything can well be, and at the same time the bank has its funds invested in a liquid form of security. If the notes purchased are properly distributed as to maturity (the Federal Reserve Board has urged the reserve banks to arrange their rediscounts in such a manner that approximately a third of them will become due every 30 days), the bank can look forward to replenishing its reserve at any time merely by the process of refusing to make additional loans, and by accumulating funds from the maturing commercial paper as it is paid off.

Loan and Discount Department.—The work of handling loans and discounts is performed in a small bank by one or two officers,

by a few more in a bank of larger size, and by a special department in banks of still larger size. Where the volume of business is very heavy, as in some of the larger metropolitan banks, the division of clerical work goes further and two departments are created, one to grant loans and the other to handle discounts. As the nature and purpose of the two kinds of credit advances are the same, the duties and routine work of both departments are very similar. The relationship, moreover, between the loan and discount department and the credit department is necessarily close. The work of the loan and discount department might be summed up as follows:

1. The examination and acceptance of the collateral if any.
2. Making settlement with the borrower.
3. Watching margins.
4. Caring for the items and collateral.
5. Computing and collecting interest.
6. Collecting loans and discounts as they mature.
7. Attending to rediscounts and pledges of commercial paper.
8. Keeping the records of the department and preparing reports for the officers.

Application for a Loan.—In negotiating a loan, application is made by the borrower to the proper department of the bank. If an advance on collateral security is requested, the collateral must be submitted for examination and approval; if a note is to be discounted, the credit rating of the parties to the note must be passed upon as described in the preceding chapter. When all the information concerning the borrower and his security is at hand, the application is submitted to the bank officer in charge of loans, with the recommendation of the credit department, and the decision is made as to whether the advance shall be granted.

In the placing of a stock exchange call loan, however, a somewhat different procedure is followed. Banks throughout the

country lend large sums on call to members of the New York Stock Exchange. Such lending is done direct to members of the exchange only by the banks in New York; their correspondent banks throughout the country make these loans through the New York banks.

Stock Exchange Call Loans—The "Money Crowd."—While application is often made to a bank in New York for call money, and collateral is submitted as in the case of any other loan, the more frequent procedure is for the bank with idle funds to invest to seek the borrowers. Such temporary investments are made through the New York loan brokers, or the "money crowd" as they are called. Certain members of the stock exchange make a specialty of dealing in money, just as other brokers make a specialty of dealing in certain kinds of securities. The money brokers come together at a specified place on the floor of the exchange, called the "money post," and there offer for loan on call the surplus funds which the city banks have available. As was said before, these funds comprise not only the money of New York banks but also the surplus funds of country banks sent to New York for investment. The brokers announce that they have certain sums of money to loan and then ask for bids, that is, the rate the borrowers are willing to pay for the temporary use of the surplus funds.

The Call Loan Rate.—The rate is determined by supply and demand. From the offerings and bids received, the brokers determine what the rate for money shall be for that day. They first establish the renewal rate for the given day. This rate applies to all loans which are to be continued from the preceding day. During the remainder of the day attention is devoted to the making of new loans, and the rate which is obtained for these is spoken of as the market rate. This rate, it is obvious, is changing from time to time during the day according as supply and demand

fluctuate. In most instances, banks instruct their representative to loan at the market rate. Some banks, however, are willing to lend to their own depositors at less than the market rate, some of these banks having fixed a maximum of 6 per cent for such loans regardless of the market rate.

The lending bank determines the size of the individual loans which it wishes to have placed. Call loans range in size from $25,000 to $500,000, but $100,000 is usually regarded as the minimum. Loans for smaller amounts are considered odd-lot transactions, and such loans are usually more difficult to place than the larger ones. When rates are published, they apply to loans made in blocks of $100,000 or more.

After the broker has received notice of the terms—as to amount, rate, and blocks—on which the bank wishes its loans to be placed, he places the individual loans as he finds bidders who are willing to take them in accordance with the terms he is empowered to make. After he has placed the loans, he notifies the bank of the name of the borrower, the amount loaned, and the rate. Later in the day the borrower appears at the bank with his collateral and obtains the funds. The brokers handle this work for the lenders, sometimes on a salary and sometimes on a commission basis, at a rate agreed upon between them.

The Call Loan Contract.—In making stock exchange call loans, no note is used. Instead of a note, each borrower signs and deposits with the bank a contract (Form 25) which covers all the loans made to him while he continues to be a borrower. The contract authorizes the bank to use the borrower's collateral in settlement of any indebtedness which may be owed by him. It gives, further, a lien upon the borrower's deposit balance and any of his securities in the bank's possession in case the collateral deposited for the specific loan is not sufficient to pay it. The bank is authorized to require additional security at its option, and to foreclose the loan without notice in case the additional security

Whereas, the undersigned expect, from time to time, to borrow money from THE NATIONAL CITY BANK OF NEW YORK (hereinafter called the Bank) and to pledge with the Bank property of various kinds as collateral security for the payment of such loan or loans to be hereafter made by the Bank; Now, therefore,

It is Agreed by the undersigned with the Bank, that all property thus pledged with it may be held by it as collateral security for the payment of such loan or loans as well as for the payment of any other obligation or liability, direct or contingent, of the undersigned, or any of them, to the Bank, due or to become due, whether now existing or hereafter arising; and the undersigned agree to deliver to the Bank additional securities, or to make payments on account to its satisfaction, should the market value of the said securities, as a whole, suffer any decline. The undersigned hereby give to the Bank a lien for the amount of all such obligations and liabilities upon all the property or securities now or at any time hereafter given unto or left in the possession of the Bank by the undersigned, whether for the express purpose of being used by the Bank as collateral security, or for any other or different purpose, and also upon any balance of the deposit account of the undersigned, or any of them, with the Bank.

On the non-performance of this promise, or upon the non-payment of any of the obligations or liabilities above mentioned, or upon the failure of the undersigned, forthwith, with or without notice, to furnish satisfactory additional securities, or to make payments on account, in case of decline, as aforesaid, or in case of insolvency, bankruptcy, or failure in business of the undersigned, or any of them, then and in any such case, all obligations and liabilities, direct or contingent, of the undersigned and each of them, shall forthwith become due and payable without demand or notice; and full power and authority are hereby given to the Bank to sell, assign, and deliver the whole of the said securities, or any part thereof, or any substitutes therefor, or any additions thereto, or any other securities or property given unto or left in the possession of the Bank by the undersigned, whether for the express purpose of being used by the Bank as collateral security, or for any other or different purpose, or in transit to or from the Bank, by mail or carrier, for any of the said purposes, at any broker's board, or at public or private sale, at the option of the Bank, without either demand, advertisement or notice of any kind, all of which are hereby expressly waived. At any such sale, the Bank may itself purchase the whole or any part of the property sold, free from any right of redemption on the part of the undersigned, which is hereby waived and released. In case of any sale or other disposition of any of the property aforesaid, after deducting all costs, or expenses of every kind for collection, sale or delivery, the Bank may apply the residue of the proceeds of the sale or sales so made, to pay one or more or all of the said obligations or liabilities to it, whether then due or not due, making proper rebate for interest on obligations or liabilities not then due, and returning the overplus, if any, to the undersigned, who agree to be and remain liable, jointly and severally, to the Bank for any deficiency arising upon such sale or sales. The undersigned do hereby authorize and empower the Bank, at its option, at any time, to appropriate and apply to the payment and extinguishment of any of the obligations or liabilities, hereinbefore referred to, whether now existing or hereafter contracted and whether then due or not due, any and all moneys now or hereafter in the hands of the Bank, on deposit or otherwise, to the credit of or belonging to the undersigned, or any of them.

The Bank may assign or transfer this instrument and may deliver the said collateral security or any part thereof to the transferee or transferees, who shall thereupon become vested with all the powers and rights above given to the Bank in respect thereto; and the Bank shall thereafter be forever relieved and fully discharged from any liability or responsibility in the matter. No delay on the part of the holder hereof, in exercising any rights hereunder shall operate as a waiver of such rights.

John Brown & Son
By John Brown

NEW YORK, Jan. 5 1921

Form 25. (a) Loan Contract (face). (Size 8½ x 5½.)

is not provided. If the loan is not paid when called, the bank is authorized to sell the collateral on the stock exchange or at public auction and to retain the funds needed to reimburse itself, returning the amount which is left, if any, to the borrower. The contract is a continuing obligation and mentions no specific loans and no specific collateral. In effect, therefore, the bank has a

> **In consideration of one dollar paid to the undersigned, and of the making of the loans referred to in the within agreement, at the request of the undersigned, the undersigned hereby jointly and severally guarantee to THE NATIONAL CITY BANK OF NEW YORK, its successors and assigns, the punctual payment, at maturity, of the loans so made, and hereby assent to all the terms and conditions of the said agreement, and consent that the securities for any such loan may be exchanged or surrendered from time to time, or the time of payment of the said loans or any of them extended, without notice to or further assent from the undersigned, who will remain bound upon this guaranty, notwithstanding such changes, surrender or extension.**

Form 25. (b) Loan Contract (reverse).

lien upon any of the borrower's property, which it may hold until the obligations due from him are settled.

Work of the Discount Clerk.—In advancing funds by the process of discounting an item, several clerical details must be attended to before the proceeds can be delivered to the borrower. When the discount has been approved and the rate at which the note is to be discounted has been indicated, the discount clerks first "time" the item. This consists in finding the due date and indicating it on the face of the note. The next step is to calculate the discount. The actual number of days which the item has to run before maturity is taken as the basis. The interest is cal-

culated on the amount due upon the note or acceptance at maturity, which amount is usually the face value of the note. If the note reads, "with interest," the interest is calculated and added to the face value of the note and the discount is calculated upon this total.

While the actual number of days are counted in arriving at the term of discount, the discount itself is calculated on the basis of 360 days to the year. The amount of the interest due on the note is usually determined by consulting interest tables, but where these are not available the calculation may be made easily in this way: First multiply the amount of the note by the number of days to run and point off two places; then divide this figure by that obtained by dividing the given interest rate into 360. The result is the interest for the given number of days. Thus, if a note is to be discounted at 6 per cent, the divisor will be 60; if the rate is 5 per cent, the divisor will be 72. The interest can in this way be readily calculated for any rate.

In addition to timing the note and calculating the interest, the discount clerk affixes the proper number of revenue stamps; and in some cases where notes are payable at some other place, he adds exchange charges. After these various charges have been deducted, the proceeds are ready for delivery to the customer.

Other Duties of the Loan and Discount Department.—The work of the loan and discount department is not confined to making loans. The employees have certain duties to perform between the time of making the loan and its eventual payment. For example, when a collateral loan is made, the loan agreement is usually to the effect that the borrower shall be permitted to withdraw at any time portions of the collateral he has deposited, provided he substitutes other acceptable securities in their stead. This is a very important privilege, inasmuch as it frequently happens that the borrower desires to dispose of the particular collateral which he has put up as security for the loan. Hence

borrowers under this arrangement are permitted to sell securities pledged with their banks, and to withdraw them for delivery to the buyer. Furthermore, when the prices for securities rise, brokers may withdraw the excess of their collateral over the bank's requirement as to margin. Or they may from time to time make payments upon their loans. In either of these cases the surrender of part of the collateral is allowed. In withdrawing collateral the borrower signs a substitution certificate, requesting the bank to deliver certain designated securities and to receive certain others from him in exchange.

Changes in Merchandise Loan Collateral.—Changes in the collateral of merchandise loans may also be made. Such collateral consists of warehouse receipts covering the commodity on the value of which a loan is granted. Borrowers frequently substitute one commodity for another, or, one grade for another grade of the same commodity. Furthermore, in the repayment of most merchandise loans, the bank permits borrowers to make partial payment and this necessitates the release of a portion of the commodity. The warehouse receipts are indivisible, but provision is made for withdrawing part of the goods in the following manner: The borrower furnishes the bank with a trust receipt or a certified check covering the full value of the collateral, that is, the goods stored in the warehouse. The bank then delivers the warehouse receipts to the borrower and he withdraws the portion agreed upon. He obtains from the warehouse a receipt covering the amount still in storage. This receipt is returned to the bank and his trust receipt is canceled, or his certified check is returned.

Goods held in storage are frequently released for purposes of manufacture or sale, or transportation to another warehouse. In such cases the borrower executes a trust receipt under which he agrees that title to the goods shall remain with the bank, that he will use the commodity released only for the purpose agreed

upon, and that he will restore the value of the commodity to the bank after it has served the purpose agreed upon. Though a trust receipt depends for its value upon the credit standing of the party who executes it, such a document exercises also a certain restraint upon the borrower, since it makes him liable to criminal prosecution for misapplication of the commodity held or of the proceeds of the commodity if it is sold. Of course, in accepting new collateral for any form of secured loan, the bank subjects the new collateral to the same scrutiny that was given to the old collateral.

Collateral Margin and Market Price.—It is the duty of all the employees in the loan and discount department to see that the margin of security demanded by the bank is maintained. As already stated, the bank may call for additional security in support of loans at any time it desires. Where the collateral consists of inactive stocks and bonds, or merchandise, or other forms of property, it is rarely necessary for a bank to give much attention to the matter of margins. Where the collateral consists of securities actively traded in on the exchange, it is necessary to give close attention to the margins, inasmuch as violent fluctuations in the market value of some of the stocks and bonds deposited as security may quickly cause a considerable shrinkage in the value of the collateral.

The loan and discount department keeps watch on the market quotations for securities pledged with the bank, and if the market price for any of these falls to a point where the borrower's margin is not satisfactory, a call is made for additional security. While a bank may sell collateral and close out loans if the calls for additional margin are not heeded, this is rarely done. Usually calls for margin are sent out in the evening, and the borrower is required to restore the margin during the next day. Since borrowers keep a record of their own margins, a call for additional security on the part of the bank is rarely necessary.

Recording Changes in the Call Loan Rate.—Still another duty devolving upon the loan and discount department during the life of the loan is to keep in touch with changes in interest rates. The usual agreement in connection with stock exchange call loans is that the bank is to charge a rate of interest in conformity with the renewal rate quoted on the exchange. However, banks do not follow this rule literally. Some banks, as already said, have a maximum interest rate for borrowers who are depositors. In connection with other loans, usually only the larger changes in rates are taken account of. If the rate is to be changed, the employees in the department record the fact in the loan ledger, so that when interest is later computed it will be calculated at these varying rates. The borrower is notified of the change in the rate as soon as possible on the day it is made. If the rate is not satisfactory, he can borrow the money from another bank and pay off his loan. It usually happens, however, that the rates charged by all banks in an important center like New York are practically uniform.

Coupon Collections and Interest Payments.—On advances that run for a long term, and on call loans which run for an indefinite period, the loan and discount department collects interest during the life of the loan. On call loans in New York it is customary to collect interest at the end of each month. On time loans, interest is usually collected not less frequently than every three months, and of course any additional interest due is collected when the loan is repaid.

During the life of the loan, the bank performs certain incidental functions such as collecting coupons from bonds held as collateral, checking up and making comparisons of collateral lists, calculating interest rates, and attending to other details in connection with borrowers' loans.

Discounts Listed for Rediscount.—Discounted notes for which collateral security has been deposited require little atten-

tion from the bank until their maturity. However, such notes may be brought out, examined, and listed for the purpose of rediscounting with the federal reserve bank. Under the provision of the Federal Reserve Act, certain of the notes and acceptances held by a member bank may be rediscounted with a federal reserve bank. That is, if a bank is in need of funds it may take some of the notes which it previously discounted for customers and present them at the federal reserve bank, and, by borrowing on these as collateral, receive the funds needed. The paper which the federal reserve bank will accept for rediscount or as collateral security for loans is termed eligible paper, and the nature or requirements of this kind of paper have been described in the preceding chapter. The decision to borrow from the federal reserve bank is made by the officers of the borrowing bank, but usually the loan and discount department is called upon to choose and prepare whatever commercial paper is to be used for securing the loan. This department also prepares an application for the loan on the standard form prescribed by the federal reserve bank.

Discounts as Security for Government Deposits.—There is another occasion for handling the discounted notes before maturity; that is, when some of them are deposited as collateral to secure deposits of government funds. Such deposits must always be secured either by government bonds or by satisfactory notes and acceptances owned by the bank. Paper to be used for this purpose is pledged with the federal reserve bank, which acts as a trustee to safeguard the interests both of the government and the depository bank. The loan and discount department looks after the collection of the notes it holds against borrowers.

The Calling of Call Loans.—In the case of call loans, it will be remembered, payment may be made at the option of either party. Ordinarily the bank exercises its option to call loans only when it wishes to reduce an excessively large loan made to one borrower,

or when it desires to build up its reserves. Since the call loan can be converted into cash within a few hours, this type of liquid assets forms a very satisfactory secondary reserve for banks. Ordinarily, however, call loans run for a considerable time.

The custom in demanding repayment of a call loan is that no demand shall be made until after the loan has run for at least one day. The notice of the call for repayment is sent to the borrower as early in the day as possible, so that he may arrange to pay the loan the same day. If the call has been made before 11 o'clock, the borrower is expected to pay by 2:15 in the afternoon. The actual payment is usually made by means of a certified check, and thereafter the collateral is delivered to the owner.

Payment of Time Loans.—Time loans are collected as they fall due. The borrower is notified of the date of maturity some time in advance. He pays either by sending a remittance covering the face of the loan and accrued interest or by having his account charged with the amount. Time loans are sometimes renewed, sometimes paid in part, and sometimes prepaid. Occasionally borrowers receive funds which make it unnecessary for them to continue the loan and they therefore apply for permission to prepay it. Although the loaning bank often permits this prepayment, the practice is not encouraged because it might easily be abused. Borrowers might arrange loans when money rates were high and then prepay them when they were low, borrowing the money to do this at another bank.

Payment of Discounts.—When discounted items mature, they are presented for payment to their local makers by messengers; if the items are payable out of town they are sent through the collection department some days before maturity to a correspondent bank for collection. If the person liable for a discount is a depositor he will frequently authorize the bank to charge the

maturing item to his account. If items are unpaid at maturity, they are sometimes protested just as are checks or other collection items.

Incidental Activities of Loan and Discount Department.— Besides the work of arranging for loans, exercising supervision over them while they are in the hands of the bank, and collecting them when due, the loan and discount department is charged with certain other duties. One of these is the loaning of money on behalf of the bank's correspondents. As was said before many out-of-town banks rely upon institutions in several of the large cities to make loans for them on call, or to buy commercial paper for them.

Another incidental activity of the department is that of keeping statistical records and making reports of various kinds to the bank's officials as an aid to the work of management. The most important records are those of earnings on loans and discounts. The earnings from loans are not received until the loans mature, or at least until after they have run for some time; whereas the earnings from discounts are collected when the advance is made. This difference in procedure gives rise to two different methods of accounting for earnings.

In the case of loans the bank must keep a record of the interest accrued thereon but not paid, because each day the loan runs the bank is entitled to interest earned. Such accrued interest is usually recorded in an "Interest Earned but Not Paid" account. In accounting for the earnings from discounts the situation is reversed; here interest is paid in advance. As each day passes, another portion of the interest already paid is earned. To record the true condition of the discounts from day to day, an account is usually opened entitled "Interest Paid but Not Earned." The first account represents an asset and the second account is a liability. Earnings from both sources are credited to the Profit and Loss account in the general ledger, and ultimately

appear along with other earnings as undivided profits on the liability side of the bank statement.

At the end of each day's business, the loan and discount department presents a summary of the entries arising from the department's work. This record corresponds in some degree with the daily proof made up in the other departments.

The Department Records.—The chief records of the loan and discount department consist of the following:

1. Loan cards, upon which are entered the name of the borrower and the details concerning the loan, such as the rate of interest, a detailed list of the collateral deposited, and any other information which may be useful in connection with the transaction.

2. The loan ledger, the purpose of which is to provide a detailed record of each loan outstanding.

3. The loan tickler, a book with a page devoted to each business day, so that the total of all loans maturing on a particular date may be ascertained immediately by turning to the proper page.

4. The loan journal, in which the loans made each day are entered consecutively. The entries for each loan consist of a debit representing an increase in the assets of the bank and a credit representing the payment of the loan to the customer. The debit side of the journal shows the names of borrowers, the rate of interest, and the amount of the loan debited to the proper general ledger account, Demand Loan or Time Loan. The credit side shows a credit to the Cashier's Check account or to the customer's account.

5. The customers' liability ledger (Form 26), containing a page or section for each borrower. The heading of the account contains, besides the name and address of the customer, the business he is engaged in; the names of those having authority to borrow for the account; those having authority to sign; guaran-

DISCOUNTS

F. R. D. 2

Omega Manufacturing Co. New York City

BUSINESS Cutlery

LIABLE AS ENDORSER

POWER TO BORROW 1/19/18 President, Vice-President, or Secretary

POWER TO SIGN Any two officers

GUARANTEE Our form continuous 1/19/21 300 m John Doe, Albert Smith, Samuel Stylus

MAXIMUM YEAR 1919 — $100,000.
1920 — 125,000.

DATE 1921		RATE	MAKER	ENDORSER	DUE 1921		DISCOUNTS		PAYMENTS		BALANCE	
											100,000	00
March	22	6	Own note	Hubbard Cask	May	7	10,000	00			110,000	00
May	7		Maturities						10,000	00	100,000	00
June	2		Maturities						100,000	00	— 0 —	

Form 26. Customers' Liability Ledger. (Size 14 x 20.)

tors, if any; the maximum amount under discount during the coming year; and the customer's liability as an indorser. This record enables the department and the officers to know at any time to what extent any individual borrower is liable to the bank, either for himself or as an indorser for others.

CHAPTER XIX

INVESTMENTS IN SECURITIES

Major Sources of Bank Profits.—A bank has two major sources of profit from the funds which it uses: the profits on loans and discounts, and the profits on the purchase and sale of securities. Some banks derive profit from the ownership of real estate, from the purchase and sale of farm mortgages, and from other uses of their funds; but the two uses mentioned above are those to which the resources of a bank are most frequently put.

Loans and discounts are not expected to tie up the funds for a long period and such advances usually mature in 30, 60, or 90 days. Though some of these obligations may be renewed, the majority are met and the bank always has the option of requiring any of them to be paid at maturity. They represent a highly liquid form of investment. The purchase of bonds or securities, on the other hand, contemplates the tying up of funds for a longer period and the investment is of a relatively fixed character. While, therefore, most commercial banks may hold securities, such investments are considered to be of a savings bank rather than of a commercial bank nature.

The two preceding chapters have dealt with the profit derived from loans and discounts; in this chapter will be considered the profits arising from investments in securities.

The Nature of Bond Investments.—The published statements of the majority of commercial banks contain among their assets a heading "Bonds and Other Securities." These items generally consist of government bonds and corporate obligations, and in some cases even shares of stock. Objection has been made to the purchase of corporation stock as a bank investment on the

ground that the stockholder is a proprietor or partner in the business and as such has no claim upon the assets of the concern until all other claims are satisfied. His claim for dividends is preceded by the claims of the bondholders and of the preferred stockholders who must be taken care of before dividends can be declared on the common stock. Investment in bonds, accordingly, is supposed to indicate a stronger financial position on the part of the bank than large holdings of corporate stock. Bonds are usually based upon tangible property values; they bear a fixed rate of interest which must be paid before any distribution of dividends may be made; and the bondholders, if their interest be not paid, may seize the property and sell it, taking sufficient of the proceeds of the sale to repay to themselves both principal and interest.

In spite of the general recognition of the fact that the return on stocks is too uncertain to recommend them as an investment for bank funds, it is true that many banks have invested, and to some extent do still invest their funds in stocks. One important exception, moreover, must be made to the statement that they are not expected to buy shares of stock. The Federal Reserve Act requires each member bank to subscribe an amount equal to 6 per cent of its paid-in capital and surplus to the stock of the reserve bank in its district.

Motives for Buying Bonds.—A considerable portion of the bonds held by banks today consists of the Liberty and Victory bonds which were floated during the Great War. The purchase of these securities was dictated not primarily by investment considerations but rather by patriotic motives. Part of the war service of the banks was to purchase war bonds as liberally as possible for themselves and to aid in every possible manner in the distribution of the bonds among the public. While this statement applies to the original subscriptions for the bonds, purchases made later, when these bonds sold considerably below

par, were dictated by a sound and shrewd policy of careful investment.

Other reasons bring about the investment of a bank's funds in various types of bonds. Under the National Banking Act, those national banks which desire to issue bank notes are required to purchase government bonds of certain issues for deposit with the Treasury Department as security for their note issues. Furthermore, government, state, and municipal bonds, as well as certain other types of securities, are accepted as security for Treasury deposits. The laws permit the Secretary of the Treasury and the Treasury officials of the minor political divisions to deposit public funds in national and state banks, provided the banks guarantee the security of such deposits by depositing with such officials bonds of a prescribed character to an amount equivalent to or greater than the funds deposited. The desire of banks to obtain these deposit accounts leads to extensive investment of their funds in bonds of the three types just mentioned.

Bonds as a Secondary Reserve.—Another reason for the popularity of bond investments among American banks is that such investments are looked upon as providing a good secondary reserve. Commercial banks receive mainly deposits which are subject to withdrawal on demand or on very short notice. For this reason they must keep the bulk of their assets in such liquid form that they can meet any sudden demands made upon them. The main reserve, or what may be called the first line of defense, is of course the cash on hand, or in the federal reserve bank, and the maturing short-time obligations which are represented by loans and discounts. It is desirable, however, for banks to invest some of their funds in securities which will not mature so rapidly and which therefore will not require reinvestment so frequently. While a bank needs some investments of a permanent character, no bank can afford to invest its funds in securities that will tie up its assets for a long period. A solution of the problem seems to

lie in the purchase of bonds, which investments, though they usually run for long periods of time, are presumed to be highly liquid inasmuch as they are dealt in freely on the leading stock exchanges. The banker regards them as his secondary reserve in the sense that, while they give him a long-time investment, he can realize upon them if necessary on short notice. This is the justification usually given for the investments made by banks in such securities.

Investigation has shown, however, that these securities are not as liquid as many bankers have thought. While it is true that there is nearly always a ready market for sound bond investments, it by no means follows that a bank can sell them at the price paid for them. In a falling market the price of all bonds declines, more or less, good and poor alike. It has been shown by students of the subject that in times when money is plentiful banks buy large quantities of bonds on the theory that they can dispose of them when necessary for cash. Usually, however, when the pinch comes and they need money, the price of securities is declining. At such a time to realize on the investment might result in a considerable loss. Hence the bank holds the securities and tries to strengthen its position by accumulating cash and compelling the payment of loans. That which was designed to serve as a secondary reserve becomes a permanent investment and is not used as a reserve at all.

Opportunities for Profit from Corporation Securities.—Undoubtedly one of the most important reasons for the purchase of corporation securities by banks is the opportunity thus afforded for profit. Many of these securities yield a higher rate of return than other types of investment, and many bring with them incidental advantages which increase the bank's profits or extend its business in indirect ways. Some banks also participate in underwriting operations, and as a result either buy stocks for their own account voluntarily, or are compelled to

take their portion of the securities which the syndicate is unable to sell.

It is important to note that the total investment of banks in bonds and securities has been growing with great rapidity. On theoretical grounds this would seem to be an undesirable tendency.

Investment Service for Customers.—While all banks to a greater or less extent make investments in bonds and securities for their own account, many of them also buy and sell securities for their customers. In such transactions the bank does not itself go into the stock market and buy securities; it acts merely as an agent, turning over the execution of the order to a regular member of the exchange. This business has assumed such large proportions in the activities of some of the large banks that they have organized affiliated bond and investment houses to care for these transactions. Where the bank itself acts as agent, a particular official may be given charge of the work; or if the volume of the transactions is large enough, a separate department such as the bond department may be created. The purchase and sale of securities may be carried on for profit or merely as a service to customers.

An investor in the interior of the country may ask his banker for advice about the investment of his savings, or he may ask that a particular security be purchased for him. The bank, having no direct connection with the security market, sends the order or request for information to its city correspondent, and the correspondent in turn obtains the information or has the order executed on the stock exchange. Frequently national banks in the smaller towns and cities request their city correspondents to purchase the bonds which they require to secure their note circulation or to guarantee public deposits. The extent to which these transactions have become centralized in New York is indicated by the fact that before the war one large bank in New York City trans-

acted more than 90 per cent of the business in government bonds in the whole country.

Borrowing and Lending Bonds.—Bonds are not only bought and sold by banks; they are also borrowed and loaned. This practice is not so common now as it was a few years ago. The effect of the monopoly granted to United States government bonds of specified issues of serving as collateral for securing note circulation and public deposits was to give these bonds an abnormally high value on the market, a value so high, indeed, that there was no profit in owning them. Under these circumstances many banks seized favorable opportunities to dispose of their holdings of government securities. To provide for their needs in governmental collateral, the banks then arranged to borrow from some other owner of government bonds the securities they required. The owner of the bonds was secured by a trust receipt and the borrower, that is the bank, paid a moderate rate or fee for their use. This charge, added to the interest received from the bonds, gave their owner a more satisfactory income, while the borrowing bank profited because, instead of buying the bonds at a high price and thus tying up its liquid assets, it had the use of the bonds for the payment of a small fee.

Market Value of Investment Assets.—Since the price of the securities held by a bank is constantly fluctuating on the stock market, it is necessary that their value as shown among the assets of the bank, should tally as closely as possible with their market value. It is not possible, of course, to change the figures on the books with every change in market price. The procedure generally is to list securities at the price paid for them and then occasionally to go over such investments, changing the price at which they are carried on the bank's books to correspond with the market price at such time. The difference between the original purchase price and the price at the time of

making the readjustment constitutes either a profit or a loss for the bank.

Accrued Interest on Investment Securities.—To ascertain a bank's earnings up to a given date, it is necessary to account for the constantly accruing interest on its bonds. Bond interest is paid at stated intervals, usually twice a year. In the interval between these payments, however, a certain amount of interest accumulates daily. It is therefore necessary, if the bank wishes to make an accurate statement of its financial position, to keep a record of the amount which each day adds to the interest due on its securities. This revenue is usually recorded in an Accrued Interest account.

Record and Custody of Securities.—The safe-keeping of a bank's securities demands care and consideration. Not only do they represent a large value in small bulk, which might easily be concealed and carried away, but they are also frequently in a negotiable form which makes them the more easily disposed of by unscrupulous persons. Accordingly, careful records are made of the securities as they come into the possession of the bank; and while in its possession they are kept in special compartments in the vaults to which only specially designated officials or employees have access. As a further safeguard it is the common practice to permit securities to be removed from the vaults only when at least two authorized persons are present.

The records kept vary with different banks. In general, what the bank requires is a complete description of the securities, including in every case the serial number, the amount, the date purchased, the market price, and similar data. For convenience in obtaining information in regard to any bond issue, most banks maintain a file of security cards on which appear such data as the rate of interest, the number of bonds held, the date when interest is due, and so on. Any information relative to bond investments

which the bank officials may have occasion to seek can thus be obtained readily without actually examining the bonds themselves.

Reinvestments.—The managing officials are kept informed as to the maturity dates of the bank's bond investments, and are also informed as to the amount of bonds on hand and the amounts purchased from day to day. This enables them to make plans for the reinvestment of funds which are likely to be received in the near future.

CHAPTER XX

KEEPING THE INDIVIDUAL LEDGERS

Information Furnished by Bank Accounting.—Bank bookkeeping is frequently said to be the simplest form of accounting. Whether this be true or not, it is certain that when the subject of bank accounting is looked at as a whole it seems very complicated. The reason for the seeming difficulty is the fact that it is necessary for the bank, because of the nature of its operations, to maintain a very complicated system of checks and controls. The same operation from the accounting point of view may be performed several times so that each entry may serve as a check upon the others. This duplication of entries is clearly seen when a bank employs two men to make exactly the same postings. The work done by one is verified by comparing it with the work done by the other.

The entries required for the actual recording of banking transactions represent a small fraction of the work done by the accounting departments. The nature of the accounting is determined by the information required. Stated in their simplest terms these needs may be said to consist of:

1. A history of transactions as they occur for future reference and reminders of matters to be attended to from day to day; these needs give rise to the journal and tickler records.
2. Information as to the bank's position with reference to its customers; the customers or individual ledgers meet this need.
3. Information from which the bank can draw up its balance sheet and can determine its profit and losses; this need is met by the general or controlling ledgers.

Records which give these three types of information comprise all that is essential in bank accounting.

Essential Books for Bank Accounting.—The books which have been found convenient for keeping the above records may be divided into two groups: those which contain the records of the bank's activities and of its relation to its shareholders; and those which contain the financial records of the bank in its relation with people other than shareholders. In the first group the books used are the minute book, the stock ledger, stock certificate book, and the stock transfer book. The second group includes the following books: journals, general ledgers, customers ledgers, certificate of deposit register, cashier's check register, draft register, loan register, collection register, tellers' settlement books, scratchers and ticklers.

Accounting in a Small Bank.—In a small bank the work of recording transactions with customers may be performed by one or more men; in a metropolitan bank the clerical work may require the services of a large number of employees. Although the transactions of a large bank may be much more numerous and although verification may take place more frequently, the work yields nothing more in the last analysis than does the simple bookkeeping and small numbers of entries performed by one man in a small bank. The activities carried on in the larger banks seem to be more complicated merely because of the greater division of labor. If this point be kept in mind the understanding of bank accounting is simplified.

Books of Original Entry.—The work of entering transactions in journals, books of memoranda, and ticklers is performed at the time the transactions occur by the persons who handle them. Thus, when deposit slips are given to a bookkeeper to be posted to the accounts of customers, he or his assistant writes the name

of the depositor and the amount of the deposit in the deposit journal. Or, when the note of a customer is discounted, a record of the amount, date, due date, signer, indorser, and place of payment of such note, is entered on a discount or loan tickler. The purpose of these books of original entry is to keep a record of each transaction as it occurs so that, if any of the documents should be misplaced, a record would be at hand for reference.

At the end of the day's business these various books of original entry are totaled. If all entries have been made correctly, the total will correspond with the total of the deposits, discounts, or checks, or whatever items they record which have been handled by the departments concerned. To make the entries in these books requires merely the clerical labor of writing in names, amounts, and dates in accordance with the headings of the various columns in the book. The procedure is so simple as to require no extended explanations.

The Individual Ledger Bookkeeper.—The work of the individual or customers ledger bookkeeper in its simplest terms consists of posting checks and deposits to the accounts of individuals, and keeping a constant record of the balance in each account. Certain deposit items, which are represented by deposit slips, are received for credit to the accounts of the bank's depositors. Certain other items, i.e., checks, represent orders transmitted to the bank by these depositors to pay portions of their balance either to themselves or to others. These checks are to be charged to the accounts. The work of the bookkeeper consists of entering in the column set aside for checks the charge items, and in the column for deposits the credit items. He then adds the deposits to the balance already standing on the ledger, subtracts the amount of the checks, and brings down the balance remaining in the customer's account. Although there are certain incidental duties for the bookkeeper to perform, the brief statement just given outlines the main portion of his work.

The General Ledger Bookkeepers.—In addition to the detailed records showing the financial relations between the bank and individuals, the management desires to know the bank's position with relation to customers and stockholders *en masse*. That is, besides knowing the amount of the credit balance of John Smith, William Jones, and various other depositors, the bank officials desire to know the total amount that the bank owes to all its depositors. The same thing is true with regard to loans. In addition to knowing the amount of A's borrowing from the bank, and B's borrowing, it is necessary to know the total of all loans made by the bank.

Furthermore, the bank is a private corporation the functioning of which is made possible by contributions of funds from various individuals in exchange for the bank's capital stock. The assets of the bank after all other claims are satisfied belong to these shareholders or proprietors. It is necessary, therefore, that the bank keep an account with these proprietors; that is, it is necessary to show the status of the capital account.

In simplest terms, then, it is the function of the general ledger to record changes in the bank's financial position with reference to the proprietors and to other persons in the aggregate. Accordingly, any change which increases the bank's indebtedness or responsibility toward others becomes a liability, and any transaction which increases its stock of valuable goods or claims against others is reflected in a growth in its assets.

The work of the general ledger bookkeepers will be discussed in more detail in the following chapter. In this chapter is considered the actual practice of the bookkeepers in handling the material to be entered upon the depositors ledgers.

Personnel for Customers Ledgers.—The work in the depositors ledger department is performed by a bookkeeper for each ledger, by statement clerks (sometimes one for each ledger) and such clerical assistants as are needed. The duties performed by

these various employees will be made clear when the routine work of the department is discussed. In addition to these employees, certain large banks have what they call a check desk where the data and items to be entered on the books are prepared for posting. In smaller banks this preparation is done by the bookkeepers and their assistants. The actual bookkeeping operations in the department consist of making postings to the depositors' accounts and of preparing statements of accounts to be rendered to customers periodically. These two operations are performed concurrently and one acts as a check upon the other.

Depositors Ledgers Classified.—In a bank of any considerable size it would be a physical impossibility for one man to look after all the accounts of the depositors. Hence, all large banks divide the accounts into convenient units and assign one bookkeeper to each unit. These units generally consist of the accounts kept in a single ledger volume, although, if the clerical force for any reason is inadequate, exceptionally expert bookkeepers may be given charge of more than one ledger. As has been said, a statement clerk is usually assigned to each ledger.

The usual method of dividing the accounts is on the basis of the alphabet. Thus one ledger may contain all accounts from A to G; another from H to M; a third from N to Z; or, if the number of accounts is very large, the divisions may contain still fewer letters. In addition to this method of division, some banks carry the accounts of their women customers on separate ledgers. Savings accounts are always kept in ledgers distinct from the checking accounts because different regulations apply to them.

In the large metropolitan banks, which carry the accounts of a great many other banks, a further ledger classification may be made. For example, one of the largest banks in the United States divides its accounts into the following main divisions: individual accounts, national bank accounts, state bank accounts, trust company accounts, and savings bank accounts. Within the

various ledgers, of course, these accounts are arranged alphabetically, the individuals by surnames and the banks by cities.

Preparation for Posting.—The work of preparing the material for posting is carried on continuously, and consists in sorting the items according to ledgers to facilitate posting. Thus, to use the divisions suggested above for the different accounts, an assistant in the receiving teller's cage sorts the deposit slips to be posted into three main divisions, according to whether the accounts appear in the A–G, H–M, or N–Z ledger. A list is made of the deposits and retained as a record from which the receiving teller makes up his daily proof. The list is afterward used to verify the total of deposit slips as posted by each bookkeeper. When these slips are turned over to the bookkeeper or an assistant, another record is made of them and they are totaled to see that the total agrees with the amount recorded by the receiving teller. The slips are then sorted alphabetically as the accounts appear on the ledger.

The Work at the Check Desk.—A similar procedure is followed in dealing with checks. All checks to be charged to individual accounts are listed and turned over to the bookkeepers, each bookkeeper receiving the checks drawn on accounts appearing in his ledger. The lists for checks sent to each bookkeeper are preserved among the records of the paying teller, and before they are distributed for actual posting another list is made to see if the total corresponds with the amount claimed by the paying teller. The deposits and checks are then recorded in the journals or "scratchers" and the totals at the end of the day in these books must correspond with the totals as shown on the original lists.

In large banks, where a very large number of items is handled, the work is further subdivided and specialized so that a considerable part of the preparation for posting is done before the items are actually turned over to the bookkeepers or their assistants.

As previously stated, a check desk is sometimes maintained for the purpose of receiving all checks and other cash items from the paying teller, the clearing house department, the mail teller, the foreign teller, and any other department which may have items to be charged to customers' accounts. The work of the check desk department consists in sorting the items according to ledgers and proving the accuracy of the charges to the bookkeeping department made by the various departments. Any errors that have been made are adjusted by the check desk.

Where a check desk is operated the work of posting is reduced by using an adding machine to list the items to be charged to each depositor's account. The checks of each depositor are fastened together and this list is attached to each parcel. In posting, then, the bookkeeper need not bother with the individual checks; he posts merely the total figures.

In banks which do not operate a check desk this work usually devolves upon the bookkeeper or his assistant. If there are only a few checks the bookkeeper posts them separately; but if a considerable number are to be charged to one account, a list is usually made and only the total is posted, while a memorandum is made on the ledger of the number of checks included in such total.

The Customers or Boston Ledger.—The form of ledger used for depositors' accounts varies in different banks. One of the forms most commonly employed is known as the Boston ledger and is illustrated in Form 27. This ledger is made up in bound form, with a sufficient number of pages to last about six months. In the center of the page, or sometimes at the left side of the page, appears a column in which the names of the accounts are entered in alphabetical order, one to each horizontal line. Blank spaces are left at various places on the page so that new names may be inserted in alphabetical order as new accounts are added during the period in which the ledger is in use. Each page is ruled ver-

July 20, 1921 Debit	July 20, 1921 Balance Credit	July 21, 1921 Debit	July 21, 1921 Balance Credit	July 22, 1921 Debit	July 22, 1921 Balance Credit	Names	July 23, 1921 Debit	July 23, 1921 Balance Credit
16,000.00	26,000.00		10,000.00 5,000.00	1,000.00	15,000.00 500.00	Waan C F New York City		14,500.00
	70,000.00		70,000.00	7,000.00	70,000.00	Waan H W Sect N. Y. C.		63,000.00
50.00	4,619.00		4,569.00 2,000.00		6,569.00 2,000.00	Waan W A N. Y. C.		8,569.00
6.50	909.00		893.50 100.00		993.50	Waco H. Detroit Mich.		993.50
	16.00		16.00		16.00	Watson R. E. N. Y. C.		16.00
76,172.50	142,719.00	100.00	66,546.50	14,096.72	66,446.50	Watson B. P. Bellevue F.		52,349.78
	1,616.13		1,616.13		1,616.13 25.00	Watson W. D. N. Y. C.		1,641.13
1,960.00	2,410.10 500.00	76.14	950.10		873.96 100.00	Wayne E. M. London C.		973.96
						Wayne Jr. E. M. N. Y. C.		
						Wets Wm N. Y. C.		

Form 27. Customers Ledger. (Size 19 x 12.)

tically into columns, one for each day's entries. The whole page contains six groups of columns, enough for one week's work. Within each of these six groups there is a column for debits to the account for the day, and a column for the credits and for the pencil balance. The advantage of this type of ledger is that a considerable number of accounts with their changes in daily balance can be presented on the same page.

Another form of ledger, used by many banks, is one in which a page or more is allotted to each account. The name of the account appears at the top and the page is then ruled off with columns for date, memoranda, checks, deposits and the daily balance, with frequently an additional column for recording the average daily balance of the account.

The advantages of this type of ledger is that more space is available for entries to each account, and therefore if a number of deposits or a large number of checks are to be posted to the same account each day, the postings will not be in summarized form as in the Boston ledger. A further advantage is that the history of a given account can be traced over a considerable period on the same page; whereas in the Boston ledger, as has been said, each sheet gives the history of its accounts for only six days.

Loose-Leaf Ledgers—Posting Machines.—Bank ledgers may be in either loose-leaf or bound form. One of the disadvantages of bound ledgers is that, inasmuch as new accounts are being opened constantly and old accounts are being closed, the active accounts soon get out of strict alphabetical order and it becomes more difficult and requires more time for the bookkeeper to locate an account and to make his postings therein, or to refer to an account. Furthermore, the bound ledgers necessarily contain a large number of blank sheets when first put in use, and toward the latter period of their usefulness they contain many dead sheets devoted to accounts that have been closed or to past records of active accounts which are referred to only occasionally.

The disadvantages of bound books are so apparent that banks are more and more making use of loose-leaf ledgers in which pages can be taken out when accounts are closed and new sheets can be inserted as accounts are opened. Since the pages are loose and can be shifted around, they can always be kept in their strict alphabetical order.

Bookkeeping Errors.—The routine work of the bookkeeper comprises posting the debit and credit items, proving and checking the postings, and noting on the ledger the new balance resulting in each account from the day's operations. The postings are made in accordance with the headings for each column. While the directions are explicit and the work can easily be performed, a certain danger of error exists. Postings must be made with great rapidity if the bookkeeper is to have his work completed at a reasonable hour. In his haste he may make any one of the following errors:

1. A charge item may be posted in the column for credits, or vice versa.
2. A charge or credit item may be posted to the wrong account; thus, a check on John Brown's account might be charged to James Brown's account.
3. An error may be made in posting the amount of a check or deposit.
4. In computing the new balance to be brought down, an error in addition or subtraction may be made.

Any of the errors listed under points 1, 3, and 4 above would result in throwing the ledger out of balance; for example, if a check for $101 were posted as $100, the balance of the account in question would be $1 less and the total balances for that ledger would be $1 less than would be indicated by the general ledger figures for the total of all balances on such ledger, assuming that the amount of the check has been properly listed in the other departments of the bank. Or, if an error were made in calculating

the particular balance, the total balance on the customers ledger would not agree with the total of such balances as recorded in the general ledger. It is part of the duty of the bookkeeper, therefore, to prove the accuracy of his ledger first as to total balances.

Proving the Ledger.—To make this proof the bookkeeper takes the total balance of all accounts in his ledger for the preceding day when it presumably agreed with the general ledger figures. To this total he adds the sum of the credits for the given day as indicated by the total deposits in his ledger. The figures for deposits are verified by comparing them with those recorded by the receiving teller and the other departments which have sent items for posting. From the gross credit thus indicated he deducts the sum of the debits for the day, obtaining the total from the records of those who have sent debits to be posted. The amount thus obtained should agree with the total balance shown by the accounts in his ledger. If it does not, it is evident that he has made an error in one of the ways indicated.

The Statement as a Check on the Bookkeeping.—The proof described above, however, does no more than demonstrate that the total balance in the ledger is correct. It does not prove that error noted under point 2 has not been committed. So long as the correct amount has been charged or credited on the ledger, the total balance would be the same regardless of whether the posting has been made to the correct account or not. A check on this portion of the work is provided by the work of the statement clerk.

This clerk keeps a ledger which is practically identical with the main ledger, in that the same amounts are posted in this record as the bookkeeper posts. It is the custom in many banks, after all postings have been made, to have the statement clerk call off the postings to the bookkeeper on the corresponding ledger. In this

way, if the bookkeeper has posted an item to the wrong account, the error will usually be detected because it is not likely that both employees posting independently will make the same mistake. This procedure furnishes a check upon the amounts posted, and the balance brought down by the statement clerk furnishes a check upon the balance computed by the bookkeeper.

When a bank uses loose-leaf ledgers the sheets kept by the statement clerk may, at the end of the month when all the work has been verified, be removed from the ledger and enclosed in an envelope with the customer's checks. The enclosure thus serves as his monthly statement.

General Ledgers a Check on Individual Ledgers.—Another standard with which the total balances in the customers ledgers are compared is the Deposit account in the general ledger. The general ledger bookkeeper commences the day with the correct total of all deposits, which total is made up from the balances of the customers ledgers. At the end of the day he obtains the totals of all charge and credit items sent to each bookkeeper. He does not bother with individual accounts and therefore has only one calculation to make. He adds, for example, to the previous total of balances in the A–G ledger the total credits for the day and deducts the total debits; the resulting balance is the amount which the ledger must show if the work has been done correctly.

Other Duties of the Bookkeepers.—Besides posting and proving the work, and preparing statements of customers' accounts, the bookkeepers frequently have another function to perform, namely, to determine the interest to be paid on customers' balances. As a special inducement to obtain deposits, some banks offer a low rate of interest on the average daily balance maintained by the customer. This interest is sometimes credited to the account monthly and sometimes only at semiannual intervals. While the method of handling these calculations varies

with different banks, as does also the amount of work imposed upon the bookkeepers, the procedure is fundamentally the same.

Computing Interest on Daily Deposit Balances.—A column is provided, either in an interest ledger or in the customers ledger, in which is entered each day the balance for that day. If the account changes daily there will obviously be a different balance in the average balance column each day. If, however, the balance remains the same for several days, the entry for the average balance column is obtained by multiplying the balance by the number of days it remains unchanged. Or the same result would be obtained by entering each day the same balance. For example, if the balance in an account were $10,000 and that balance remained unchanged for five days, there might be entered in the average balance column $10,000 each day for five successive days, or a lump sum of $50,000 might be entered once. At the end of the interest period the total for the average balance column is computed, and if this is divided by the number of days in the period the resulting figure will be the average daily balance for the whole period. The interest at the given rate on $1 for this period is then computed and it only requires the multiplication of this amount by the average balance to find the interest due to the depositor.

Interest on Full Balance.—It is important to note the manner in which balances to be used for interest computations are obtained. It has been pointed out in another connection that most of the deposits consist of checks or other items which cannot immediately be converted into cash by the receiving bank, and that some of these items require as long a period as eight days for their collection. It would be obviously improper to expect a bank to pay interest on a balance made up of items not yet collected and for which in reality it does not possess the funds. To guard against this overpayment, the procedure is as follows: to

the credit balance in the depositor's account for the preceding day are added any deposits which are available for use by the bank on that day. From this sum are subtracted all debits made to this account during the day; the result is the balance on which interest is paid. This balance, it will be noted, is thus less than the actual balance by the amount of the items credited during the current day, except those items which the bank can use immediately in its loaning operations. The customer has the use of his deposit so far as drawing against it is concerned, but he does not receive interest on it if the funds are not immediately available to the bank. As soon as they become available they are added to his interest-bearing balance.

Bookkeepers Responsible for Payments.—The routine duties of the bookkeeper involve certain responsibilities. He is expected to be on his guard to see that stop-payment orders are not ignored; to prevent overdrafts; to verify signatures; and to see that items are formally correct as to date, indorsement, and amount. When stop-payment orders are filed with the bank, a memorandum is given to the bookkeeper in charge of the particular account. He makes a record of the matter on his ledger and is expected to keep the order in mind while making his postings, so that if the check which the depositor has ordered not to be paid comes to hand, he will detect it and return it unpaid.

Overdrafts.—While the bookkeeper is making his postings of charges, he constantly notes the amount of the customer's balance to see whether it is sufficient to meet the debit items he is posting. If the items to be posted overdraw the account, he ascertains first whether a deposit of an amount large enough to cover the items has been made and not yet been posted. If not, he refers the matter to the proper official of the bank who authorizes him either to charge the item, thus overdrawing the account, or instructs him to return it unpaid to the source from which it was

received. If the item is paid, the bank gets in touch with the customer as soon as possible and asks him to deposit a sufficient amount to cover the overdraft.

Signature Control.—While a bookkeeper is not usually charged with full responsibility for the signatures of depositors, he is expected to become so familiar with those of customers on his own ledger that he will readily detect any irregularity in the signature of the items he is posting. Questionable items are brought to the attention of the paying teller, or in a large bank the signature department, so that they may be examined with more care.

Circumstances arise from time to time which make it impossible for the bank to pay all items drawn on certain accounts although there may be a balance sufficient to pay them. For example, banks must exercise great care in paying checks drawn against accounts of bankrupts, deceased persons, concerns in the hands of receivers, or accounts which have been attached. When an account is legally attached in any way, the bookkeepers must be on guard against the payment of unauthorized items. To call attention to the matter and to prevent passing such items, the bookkeepers sometimes place a memorandum or a stamp of a distinctive shape or color opposite the name of each account which cannot be drawn against in the regular way. Finally, the bookkeepers are expected, while posting items, to detect any obvious errors in the date or the indorsement of checks and other papers, and to discover any alterations which have been made in the body of the item.

CHAPTER XXI

THE GENERAL LEDGER

Function of General Ledger.—The function of the general ledger, as was said in the preceding chapter, is to record changes in the financial position of the bank in the aggregate. In the general ledger the bookkeepers bring together from every department information regarding the bank's changing financial relations. In that ledger only, can one get a complete view of the bank's business—of the operations of the bank and the results yielded by them. The bookkeepers on the individual or customers ledgers may know the amount of the deposits carried in each ledger, but to ascertain the total deposits of the bank one must go to the general ledger in which the deposits recorded in each ledger are assembled. Furthermore, the individual ledger bookkeeper knows nothing about the profit earned by the bank. Even the note teller or discount clerk who collects the interest on money loaned to customers has no idea of the bank's total profits or total expenses. To obtain any information on this subject recourse must be had to the general ledger.

The Bank Balance Sheet.—A bank is at the same time both debtor and creditor; some people owe it money—for example, those for whom the bank has discounted notes; and the bank owes other people money—for example, those who have deposited money with it. The accounts in the general ledger show in any given case to what extent the bank is a debtor and a creditor. The claims of the bank against others are assets—or, as more generally termed in banking practice, resources—while the claims which others have against the bank are liabilities. The condition of the bank at any moment can be

determined by comparing the total assets or debits with the total liabilities or credits.

The Nature of the Liabilities.—The above statement brings up an accounting point of some difficulty for the novice to grasp, namely, that capital, surplus, and undivided profits appear on the liability side of the balance sheet. This arrangement creates a seeming perplexity that can be readily cleared up if one thinks of a given institution as an entity distinct from those who own it. While in a sense the bank and its stockholders are one and inseparable, to get a correct view of the financial relationship existing between them, one must realize that the bank is indebted to the shareholders for all the funds which the shareholders have contributed for carrying on its operations. It may be said, then, that a bank's statement portrays two kinds of liabilities: the bank's liability to its proprietors; and the bank's liability to outsiders or general creditors.

The matter may be further clarified by substituting the word "equities" for the word "liabilities." Thus the capital which the proprietors put into the bank and which is invested in such assets as buildings, furniture and equipment, investments, etc., represents the proprietors' equity in the property owned by the bank. Similarly, customers' deposits which appear as a liability represent the equity which the depositors claim in the property or assets owned by the bank.

The two sides of a financial statement, that is, the assets and the liabilities, should be equal. If the liabilities should exceed the assets, the bank would be insolvent; if the assets exceed the liabilities to outsiders, whatever excess remains is a liability to the proprietors. If the bank is not liable to any specific account, such as Capital account or Surplus account, the excess of assets over liabilities becomes a liability to Profit and Loss account.

Nominal Accounts and Property Accounts.—Since the general ledger deals only with summations or totals, it does not carry

accounts with individuals. It contains accounts with property and nominal accounts, that is, accounts opened to record financial changes in the bank's position in a particular respect. The Interest Earned account, the Profit and Loss account, and the Expense account are examples of nominal accounts. Real estate owned, bonds, and other securities are further examples of property for the recording of which accounts are opened. Anything that is added to the assets or resources of the bank is debited to the proper account. The amount may be considered as due from the account to the bank. Anything added to liabilities is credited to the proper account. The amount may be considered as due to the account from the bank. Thus, if a customer borrows $1,000 from the bank, the account Loan and Discount on the general ledger is debited. The Loan and Discount account owes the bank $1,000. If $1,000 is deposited by a customer, the account Individual Deposits is credited with the sum since the receipt of the amount makes the bank debtor to individual deposits for $1,000.

Checking the Work of Departments.—Inasmuch as the two sides of a bank statement must balance, the work of the general ledger bookkeeper is arranged to provide each day a check upon the accuracy of the work in all other departments by the agreement between his total entries and the totals in other departments. If an error has been made in any one of the other departments, the total of the two sides of the balance sheet will not correspond. If the receiving teller, for instance, should list a deposit of $100 as $110, the assets in the form of cash would be increased by only $100 whereas the liabilities represented by deposits would be increased by $110. Obviously so long as this error exists the total assets and the total liabilities of the bank cannot be equal.

Subsidiary and Descriptive Ledgers.—The employees in charge of the general accounts may be many or comparatively

few, according to the volume of work to be done. Where the work requires more than one man, a general ledger bookkeeper is in charge, subordinate bookkeepers work under his supervision, and clerical assistants are provided as needed. In banks where the volume of work is large, two general ledgers are sometimes opened; one carries the accounts which always show a credit balance, that is, those which are liabilities; and the other ledger carries only those accounts which show a debit balance, and are therefore assets. As the volume of business increases, other divisions are made. For the sake of convenience in operation, subsidiary and descriptive ledgers are opened, in which may be recorded the details of the transactions brought together in the general books. The general ledger merely takes the totals from the subsidiary and descriptive ledgers.

The subsidiary ledgers provide an intermediate method by which a large number of separate totals applying to the same general account are brought together and consolidated so that they may appear as one set of figures in the general ledger.

The Use of Subsidiary General Ledgers.—The function of the subsidiary general ledger may be illustrated by reference to the account Individual Deposits. Half a dozen or more separate ledgers may be required to care for the accounts of individuals. The general ledger takes account only of the total of all balances on these ledgers. Where the volume of business is large it would require too much time and space for the general ledger bookkeeper to make separate entries for the totals of each of these ledgers. It is necessary, however, if a control account is to be maintained, to preserve these figures. They are assembled, therefore, in the subsidiary general ledger. The total for all the individual ledgers is obtained from the subsidiary ledger and this is entered in the general ledger.

The figures which are posted in the subsidiary ledger each day are the total deposits for each individual ledger and the total

checks drawn upon accounts in each ledger. The entries to the account Individual Deposits in the general ledger for a given day consist of a single debit entry, a single credit entry, and a balance, without description of any kind. The economy in this procedure may be illustrated by assuming that the figures contained in this balance represent the aggregate of six control accounts, that is, an account with each of the individual ledgers brought together in the subsidiary ledger. These control accounts in turn represent six different ledgers, each of which may contain hundreds of accounts.

The Use of Descriptive Ledgers.—Similarly, the descriptive ledgers serve the purpose of recording with somewhat less detail, information obtained from other sources in regard to special accounts. This information is given to the general ledger bookkeeper in final totals for the day. The nature of the accounts carried on these ledgers may be understood by noting the titles of a few which indicate very plainly their purpose: Advanced to Customers on Travelers' Letters of Credit; Accounts Receivable; Lawful Reserve with Federal Reserve Bank; Coupons; Interest; Discount; Exchange; Rent; Reserve for All Interest; Time Certificates of Deposit; and Cashier's Checks. All these accounts are handled by the general ledger department, but because a considerable number of entries occur during a day, they are first posted in the descriptive ledger. The day's total for each account is then posted to the general ledger.

The Recapitulation Sheet.—The routine work in the general ledger department consists in first accumulating the total debits and credits from all departments of the bank, and then posting the totals to the proper accounts on the general ledger. Items for posting to these accounts, which are sent to the department at various times during the day, are totaled and recorded on a recapitulation sheet. This sheet corresponds in appearance to the

statement sheets made up by the general ledger bookkeeper, and the items are posted to accounts under the names which appear on the general ledger. At the end of the day the several postings in each account are totaled and the items on the recapitulation sheet are copied into the general ledger.

The Daily Bank Statement.—Each day the general ledger department prepares a statement which is entered in a statement book. This record serves three useful purposes: it constitutes a trial balance showing that the ledger is in balance; it presents the financial position of the bank for the given day; and it makes a possible comparison of the day's figures with those of the preceding day. Such a statement presents the more important balances appearing in the general ledger as separate entries, while the less important balances are grouped together for convenience. Such an analytic arrangement greatly aids the officers of the bank in watching the financial condition of the institution and enables them to determine the business policy for the immediate future. The statement book also serves as a valuable source of reference for information as to the status of the various accounts on different dates.

Computing the Reserve.—Another duty of the general ledger bookkeeper is to compute the reserve of the bank. A national bank in a central reserve city—New York, Chicago, or St. Louis—is required to maintain at all times a reserve equal to at least 13 per cent of its demand deposits, and 3 per cent of its time deposits. The amount of the reserve required for national banks in reserve cities is 10 per cent of demand deposits and 3 per cent of time deposits; and in country banks, that is, national banks in all other places than the reserve and central reserve cities, the figures are respectively 7 and 3 per cent. This reserve must consist of a deposit balance maintained with the federal reserve bank of the district. If a bank permits its lawful reserve to fall below the

legal figure, it is subject to a fine imposed by the Federal Reserve Board, it is restrained from making loans, and its banking operations in other respects are restricted. To ascertain the daily standing of the bank's reserve account is, therefore, a most important duty. This daily standing is ascertained by comparing the bank's balance in the federal reserve bank with the bank's deposit liability. The deposit liability is computed by deducting from the total deposits held by the bank all kinds of clearing house exchanges—that is, checks on other banks in the same city—time deposits, government deposits, and the amount due from domestic banks.

Methods of Restoring the Reserve.—The officers of the bank watch very carefully the state of the reserve account and ascertain from the general ledger bookkeeper the additions to the account which may be expected from items in process of collection, the decreases which are expected on account of maturing bills payable at the federal reserve bank, and the charges which will result from the day's clearings. If it appears that the bank's reserve will be depleted, the tendency in that direction is overcome, in the case of long-term needs—up to 90 days—by rediscounting at the federal reserve bank; in the case of temporary needs, by borrowing at the federal reserve bank on a one-day note secured by United States bonds.

Recording Earnings, Expenses, Profits, and Losses.—The general bookkeepers may also be required to prepare a statement showing the earnings, expenses, profits, and losses of the bank. The earnings consist of discount and interest obtained from loans and discounts made, interest on bonds, and on the bank's balances with other banks, commissions of various kinds, and exchange (Form 28). The chief deductions from earnings are interest paid to depositors, rediscounts at the federal reserve bank, and various expenses. In many banks, statements are drawn up

THE NATIONAL CITY BANK OF NEW YORK

INTEREST EARNINGS STATEMENT FOR MONTH OF......192..

	INTEREST	Av. BALANCE	Av. RATE	JANUARY 1 TO DATE Interest	Av. Balance	Av. RATE
Interest Receivable:						
Discounts						
Loans						
Foreign Department*.....						
Stock—Bonds						
Cash Reserve...............						
Total Interest and Available Funds...........						
Interest Payable:						
Domestic Banks..........						
Individuals						
Time Deposits............						
Foreign Banks...........						
Individuals:						
Time Deposits..........						
Foreign Sundries.......						
Certificates of Deposit....						
U. S. Government Deposits						
Trust Deposits...........						
Borrowed Money.........						
Borrowed Bonds.........						
Float and Free Balances....						
Total Interest and Funds on Deposit...........						
Net Interest Earnings......						
Commissions:						
Transfers and Registrations						
Trust Department........						
Coupon Paying...........						
Miscellaneous						
Exchange						
Rent						
Sundries						
Total Interest Earnings and Commissions.....						
Less Expenses..............						
Excess Interest Earnings and Commissions						

* The investments and the deposits of the foreign division are shown merely for statistical purposes in order to arrive at the total available funds and deposits of the bank. The interest figure given for foreign investments is an arbitrary one, exactly equal to interest payable on foreign deposits, the idea being simply to eliminate foreign interest from this statement.

Form 28. Monthly Interest Earnings Statement.

monthly showing the interest earnings on the various loans and investments for the period under consideration.

In this connection it may be noted that some banks compile elaborate statistical records as to earnings from their various investments. Such records help the management to determine the most profitable methods of utilizing the bank's earning assets.

Accounting for Interest, Taxes, and General Expenses.— Other duties of the general bookkeepers may be to keep an account of the expenses of the bank, and to see that proper vouchers are prepared and presented in connection with all expenditures. The chief expenses of the bank are of three kinds: interest paid, taxes, and general expenses. The first kind of expense may be subdivided into interest paid on deposits, and interest paid on borrowed money and borrowed bonds. Money may be borrowed at the federal reserve bank or from some other bank. Taxes may be subdivided into income tax, state tax on capital stock, federal tax on circulation, and state tax on real estate. While the tax payments are made in one or more lump sums, the tax burden should properly be distributed throughout the year. To this end banks usually estimate their taxes for the year and divide the total into twelve equal parts, charging one of these parts monthly to the expense account Taxes Paid.

The general expenses may be subdivided into salaries and other expenses. The amount expended for salaries is charged each month as it is paid out. Other expenditures are estimated on a budget basis. Past experience and possible future needs are considered and the total cost for the year thus estimated is divided and charged in equal monthly portions. In a bank which does a large business, all payments on account of expenses contracted are made only on presentation of properly authenticated vouchers. One of the duties of the general bookkeepers is to record these vouchers in a voucher register or similar book, only the totals of which are posted to the general books.

Preparing Reports and Publishing Statements.—There remains to consider one other main duty which devolves upon the general bookkeepers, namely, the preparation of statements of condition where these are required. Thus the Clearing House Association in New York City compels all member banks to submit a statement of condition at the close of business each Friday, showing the daily average condition of the bank for the past week. Another compulsory statement for national banks is a report to the Comptroller of the Currency. The Comptroller is required by law to call upon national banks for statements of condition at least five times a year, and he may ask for them more frequently if he desires. These statements include schedules which go into great detail in regard to the operations of the bank and the amount of its business.

A third statement prepared by every bank is a statement of condition for publication as an advertisement (Form 29). The general bookkeepers are instructed to prepare these statements whenever it seems desirable.

Accounts on the General Ledger.—A discussion of the main accounts with which the general ledger bookkeeper deals is necessary for a proper understanding of his work.

The most important item appearing among the resources or assets of a bank's statement is that of "Loans and Discounts." This item is usually made up from a number of separate accounts, such as Demand Loans, Time Loans, Bills Discounted, and Acceptances Discounted. Another large account is that of "Bonds and Other Securities." This item likewise includes a number of separate accounts, such as State Bonds to Secure Circulation, United States Bonds Deposited, and other suitably named accounts to classify other kinds of bonds. The account State Bonds to Secure Circulation shows the government bonds which have been deposited by the bank as a basis upon which to issue national bank notes. The account United States Bonds

The National City Bank of New York and Branches

Condensed Statement of Condition as of May 4, 1920

Assets

Cash on Hand, in Federal Reserve Bank and due from Banks and Bankers and United States Treasurer	$254,008,322.18	
Acceptances of other banks	26,934,110.29	
United States Treasury Certificates.	22,813,500.00	$ 303,755,932.47
Loans and Discounts	$586,088,579.98	
United States Bonds and Other Bonds and Securities	40,079,590.07	
Stock in Federal Reserve Bank	1,800,000.00	627,968,170.05
Banking House		5,000,000.00
Due from Branches		20,470,001.51
Customers' Liability Account of Acceptances		66,068,490.77
Other Assets		4,323,191.73
		$1,027,585,786.53

Liabilities

Capital, Surplus, and Undivided Profits	$ 84,855,526.65
Deposits	720,598,397.99
Reserved for Taxes and Interest Accrued	4,846,508.31
Unearned Discount	2,902,600.02
Circulation	1,399,930.00
Due to Federal Reserve Bank	106,460,066.76
Other Bank Acceptances and Foreign Bills Sold with our Indorsement	31,753,200.11
Acceptances, Cash Letters of Credit, and Travelers' Checks	68,143,630.51
Bonds Borrowed	3,333,200.00
Other Liabilities	3,292,726.18
	$1,027,585,786.53

Form 29. Published Statement of Condition.

Deposited shows the amount of the bonds deposited to secure government deposits. Banks which are members of the federal reserve system, moreover, carry an account showing the amount of the federal reserve bank stock owned.

Miscellaneous Asset Accounts.—The two groups of assets mentioned above represent the chief liquid assets of the bank. Other accounts which appear among a bank's resources represent such assets as: Buildings; Furniture and Equipment; Accounts Receivable; Prepaid Expenses; Interest Earned but Not Collected; Cash in Bank; Reserve with Federal Reserve Bank; Redemption Fund with the United States Treasurer; and so on. Another group of accounts among the resources are: Balances Due from Other Banks; Due from the Federal Reserve Bank on Account of Collections; Exchange Due from the Clearing House; and checks on other banks in the city not members of the clearing house.

Liability or Equity Accounts.—Among the liabilities the accounts ordinarily found cover such items as: Capital Stock; Surplus Fund; Undivided Profits; Reserved for Taxes; Reserved for Interest; Reserved for Expenditures; Reserved for Depreciation; Demand Deposits—including United States Deposits; Due to Banks and Bankers; Individual Deposits; Certified Checks; Cashier's Checks; Unpaid Dividends; Demand Certificates of Deposit; Letters of Credit; Travelers' Checks; and Time Deposits.

Other liability accounts which appear less frequently are as follows: Discount Collected but Not Earned; United States Bonds Borrowed; Other Bonds Borrowed; Bills Payable with the Federal Reserve Bank; Circulation Outstanding; Accrued Expenditures; and Acceptances under Commercial Credits.

CHAPTER XXII

AUDITS AND EXAMINATIONS

Nature of Bank Audits.—The only part of the accounting work of the bank that remains to be considered is the subject of audits and examinations. As already pointed out, the process of checking and auditing the work of various departments is going on constantly. The receiving teller, the paying teller, the bookkeepers, and practically all other employees of the bank check up their work each day to assure themselves that it has been done correctly. In addition to these self-checks, every bank exercises further supervision over the work of its employees. The aim is, not primarily to make sure that the accounts balance, but that the work has been done honestly and efficiently. These additional examinations are termed audits to distinguish them from the proofs or checks which employees exercise over their own work.

Internal and External Audits.—The audits of a bank's books are not made daily as are the proofs, and they are carried out without warning. Audits and examinations are of two kinds: internal audits, and examinations by outside authorities. Internal audits, as the term signifies, are examinations made by the bank itself; examinations by outside authorities are audits covering the entire work of the bank made by persons not connected with it in an official capacity.

Protection of Stockholders and Depositors.—The purpose of these examinations or audits is to protect the interests alike of the stockholders and of depositors of the bank from loss through mismanagement. Formerly the bank's note-holders were the persons chiefly in need of protection, but since the establishment

of the national banking system and the restriction of note issues to national banks, which are compelled to secure their note issues by deposit of United States bonds, there is no longer any occasion to safeguard the interests of a bank's note-holders. The note issues themselves are protected. Hence it is often assumed that the only interests likely to suffer from the maladministration of a bank are those of its depositors, but this assumption is incorrect. The holders of a bank's capital stock are equally interested in the prosperity of the undertaking.

The stockholders of a bank may be very numerous and as a rule are scattered over a wide area. For the most part they have no intimate knowledge of the manner in which the business is being conducted; they are absolutely dependent, for the safety of the money they have invested and for adequate dividends from such investment, upon the integrity and ability of the officers and directors. Since the stockholders of all national banks and of many state banks are liable, in the event of the failure of the bank, for an additional amount equal to the par value of their stock, they need to be assured of the honesty and efficiency of the bank management. This assurance is obtained by means of an audit or examination having the three following purposes in view:

1. To show that the assets as stated on the balance sheet are in possession of the bank.
2. To determine whether the policy and management of the bank are sound and conservative.
3. To observe whether the technique of handling the business is up to date, and efficient.

The Bank's Force of Auditors.—The clerical work required for the auditing of a bank's books varies naturally with the volume of business and the number of employees. In banks employing comparatively few persons, practically all employees are intimately acquainted with the details of operation; and the close

relation of the duties of one employee to those of another renders unnecessary the expenditure of a great deal of time in checking up the clerical work. In a large institution the duties are so subdivided and the employees are so numerous that a constant scrutiny of their work is imperative. In the smaller bank such auditing as is done internally is performed by the officers or by all the employees working together to check up each phase of the daily routine. In a large institution the demands upon the auditing force are so heavy that specially trained men devote all their time to the task of auditing and much of the work is divided for the sake of efficiency.

Subdivisions in the Work of Auditing.—In one of the largest New York banks an auditing division is in charge of the books, and the auditor at the head of the division is responsible to the comptroller. The division is organized into the main departments of accounting, reconcilements, general audits, and branch bank accounting. The accounting department handles that part of the work which comprises the making of daily audits of current transactions. The reconcilement department attends to the reconciling of the bank's records with those of its depositors, with the federal reserve bank, and the foreign banks with which the bank maintains accounts. The general auditors are examiners who make periodical audits of the various departments of the institution. The branch bank accounting department is in charge of the accounting records kept with the branches of the bank, and bank inspectors make examinations of the branches at intervals.

To maintain the efficiency of the auditing staff, its work should not be too closely connected with that of the other departments of the bank. To this end the auditors are transferred from one type of work to another at frequent intervals. This shifting serves the further purpose of checking the work of the members of the audit department.

Continuous and Spot Audits.—The nature of an internal audit can be best understood by considering the various kinds of audits made by the officers or auditors of the bank. A type of audit common to most large banks is the daily or continuous audit, which differs little from the ordinary checks or balances in constant operation. The purpose of such an examination is to review or check actual transactions immediately after they have passed through the operating departments. Such routine matters as the issuing of travelers' checks, certificates of deposit, and cashier's checks, the receiving of negotiable funds not accounted for on cash proofs, making adjustments with customers, and computing earnings, require the closest supervision at all times regardless of the efficiency of the departments handling them. All these transactions are checked or audited by the accounting department as soon as they are completed.

Occasionally a test audit made by the general auditors may indicate lack of efficiency in the personnel of a department. If, for instance, errors are frequently found and the work seems to have been inefficiently done, the auditors may suggest the reorganization of the department or changes in its procedure. While a continuous audit is useful in these respects, it has two disadvantages: (1) the duplication of clerical work is expensive; and (2) the realization by employees that the records are subject to constant check tends to lessen their alertness and the feeling of responsibility for the work passing through their hands. For these reasons another form of audit, known as the spot audit, is constantly being made.

The spot audit is virtually an examination made at irregular intervals, for the purpose of checking mainly the handling of actual transactions. In making a spot audit the accountants appear in a department at intervals and check over the work of the employees for a sufficient length of time to ascertain how it is actually being done.

The Number Control System.—One phase of a bank's operations which requires careful scrutiny and is subject to continuous check or audit is the issuance of certain types of credit instruments. To prevent their unauthorized issue some banks adopt what is known as a "number control system." Under this arrangement all blank checks, drafts, and letters of credit are numbered serially and are kept in the possession of the auditing department. The operating departments are permitted to withdraw only a supply sufficient for their daily requirements. When two or more departments issue the same kind of instrument, such as a cashier's check, a distinctive symbol indicating the department of issue is affixed to the serial number. A record of the blank forms in the hands of the various departments is kept by the auditor. As the instruments are issued, stubs bearing the corresponding numbers and the authority of an officer for their issue are turned into the auditing department. By this method each department is held to strict accountability for all blank credit instruments issued to it.

General Purposes of Continuous Audit.—The auditing of such documents as cashier's checks, bank drafts, certificates of deposit, foreign drafts, travelers' checks and letters of credit, commercial credits, and telegraphic and cable transfers is performed for the purpose of ascertaining that the instruments have been issued under proper authority; that the entries have been made correctly; that the accounts in the general books are properly kept; that a stub or duplicate record is in the possession of the bank; that the proper persons have received payment; that the accounts have not been altered before payment of the items; that every stipulation made by the customer in connection with the issue of such instruments has been met; and that the necessary drafts and shipping documents conform to the terms of the credit.

Continuous audits are also made of the expenditures of the bank to see that the outlays have been properly authorized and

that the bills submitted are in proper form and amount. Shipments of money, securities, and other valuables are subjected to a continuous check to determine that they conform to instructions, that they are addressed to the proper consignee, and that the bank receives proper acknowledgment from the consignee of the receipt of the shipment. Payments and cancellation of coupons are verified constantly. The various fiduciary and representative activities of the bank, as for example, the issue of certificates of stock and the registration of bonds, are subjected to inspection to make sure that no errors have been made. Likewise, the earnings and computations of interest for the loan and discount department are constantly being audited.

The Reconcilement of Accounts.—Another important phase of the auditing work is the reconcilement of depositors' accounts, whether they are accounts of individuals or of banks. The statement of account sent out by the bank is the medium through which reconcilement is effected. These statements list in detail every debit and every credit that has appeared on the account during a given period. With this statement the customer receives the canceled vouchers and a reconcilement blank. He is requested to make a careful comparison of the bank's record with his own record. If the two records agree he enters the balance on the reconcilement blank and signs and returns it to the bank. If agreement is not obtained, the discrepancy is indicated and the auditors then check up the work to locate the error.

The General Audit.—In banks large enough to maintain a separate auditing department a general audit, similar to examinations made by outside agencies, is taken from time to time. In the continuous and spot audits the procedure is to submit some specific banking process to detailed examination while the work is in progress. In the general audit the procedure is to make a complete examination of the records, covering generally the

operations of a specific department over a considerable period of time. The movements of the auditors from department to department are guarded with the greatest secrecy. They give the work in every department very critical inspection. Each department is inspected several times a year, and special audits may be made more frequently when it seems advisable.

When an inventory of valuable assets, such as cash, securities, or notes, is involved, the auditors verify the amounts reported by actual count. Upon the completion of such an audit a report of the condition of the department examined is prepared for the use of the management and comptroller. In addition to testing the accuracy of the work done, the auditors make suggestions for improvements in accounting and other routine methods.

One other form of internal examination is that by the directors, which is required by the Comptroller of the Currency to be made periodically.

Governmental Examinations.—While many banks cannot afford to maintain separate auditing departments, and their activities therefore are not subject to the constant internal checks that have been described, all incorporated banks are subject to examinations by outside authorities. The most important of these examinations are made by professional bank examiners. If a bank is chartered under state laws, it is subject to inspection by state bank examiners. If incorporated under the National Banking Act, it is audited by examiners operating under the direction of the Comptroller of the Currency. A large bank which desires for its own protection more frequent inspection than that made by state or federal examiners will often employ in addition outside auditors, generally certified accountants, to examine every department of its work.

Clearing House Examinations.—Another examination by an outside agency is that to which the banks belonging to the clear-

ing house in certain large cities are subject. In New York and in a few other cities where large clearing house associations exist, the members of the association, for their mutual protection, employ a staff of bank examiners. These examiners devote their whole time to the auditing of the business of the various members of the association. These examinations are made unexpectedly and at irregular intervals. One of their most important features is that they enable the examiners to check up loans made by different institutions in the city to the same individuals or groups of individuals.

The purpose of these outside examinations, no matter by whom they are made, is to prevent fraud and to correct errors of management.

Examination Procedure.—Although the actual procedure in making such examinations varies, there are certain objectives which all examiners have in mind. Briefly enumerated, these objectives are:

1. The cash is counted to see whether it agrees with the paying teller's figures for the amount on hand.
2. Cash items are examined to verify the amount; if any items have been carried in the cash for some time, inquiry is made as to the reason they are not liquidated.
3. The balance shown on the bank's books as due to and from other banks is verified by the process of reconciling the accounts.
4. Investigation is made of the amount of overdrafts and inquiry is made as to the security held against these. If the overdrafts have been standing some time the question is raised as to why they have not been repaid.
5. The past-due paper is examined, and inquiry is made to ascertain the reason for its non-payment.
6. The securities owned by the bank and those held as collateral for loans are examined carefully to see that

they are in proper form and that the total value corresponds with the figures on the bank records.

7. The loans are verified for amount and form, and an examination is made of the borrowers', directors', officers', and clerks' liability both as makers and indorsers.
8. A trial balance of the ledger is obtained and the totals compared with the statement.
9. The amount of capital stock outstanding is checked and verified with the stock certificate book.
10. Throughout the whole examination care is taken to see that the bank is not violating the law and that its practice can be approved as conservative.

The Test of Solvency.—One of the purposes of a detailed audit is to show that the bank is solvent. Solvency is determined by examining the character and amount of a bank's assets to see whether they are sufficient to cover or counterbalance all liabilities. The scrutiny of a bank statement will not disclose whether or not the bank is solvent, and there is only one test by which a depositor can judge of the soundness of a particular institution. Since all liabilities must be met or liquidated by assets, the real test of the solvency of a bank is the adequacy and character of the assets. A reading of a bank statement gives little information in this respect, and it is for this reason that the examinations are important, inasmuch as a considerable part of the examiner's time is devoted to an investigation of the quality of the assets.

The outsider or the prospective depositor can form an approximate opinion as to the soundness of the institution with which he is contemplating opening an account, even though he cannot have absolute assurance of its solvency. For example, if the reader of a bank statement will multiply the amount of the bank's capital by two, and to the amount add the surplus and undivided profits,

he will obtain a figure which will indicate the margin of safety for depositors and other creditors. The difference between the total liabilities and the sum of its capital, surplus, and undivided profits indicates the amount of the liabilities which have first claim on the assets. If, for example, the total assets of the bank in question are $2,000,000, and the liabilities exclusive of the capital, surplus, and undivided profits amount to $1,250,000, there will be available $750,000 in assets in excess of the liability to the depositors and others who have first claim on the assets. But the stockholders of national banks and of most state banks are liable for twice the amount of the par value of the stock which they own. Hence, to obtain the real margin of safety for the above-mentioned bank, there should be added to the $750,000 already obtained the par value of the bank's capital stock.

The Margin of Safety.—The above calculation indicates what is known as the margin of safety. The larger the margin, of course, the more confidently the depositor may look forward to transacting business with the bank. But the fact must be emphasized that ultimately it is the character of a bank's assets which determines its safety. A margin of $750,000 or of even $1,000,000, would be insufficient if the funds were invested in unsound enterprises or if loans were made which the bank would later be unable to collect. Hence, the real protection of both depositors and shareholders from losses due to poor management or fraud lies ultimately in careful and frequent examinations of the bank's books.

CHAPTER XXIII

FIDUCIARY

Forms of Fiduciary Activity.—The remaining chapters of this book deal with certain supplementary bank activities and fiduciary functions which are not essential features of banking business, nor to be regarded strictly as banking functions. They are nevertheless closely related to many banking functions and make use of the machinery provided for banking service. Some activities of this sort have in recent years become so much a part of the work of a modern bank that they merit consideration here.

The fiduciary activities of a bank include the following: acting as trustee, executor, and administrator of wills, bequests, and estates; serving in the capacity of registrar, transfer agent, and fiscal agent for corporations; acting as receiver and custodian of securities and other valuables. Banks are well qualified to act in these capacities for the several reasons given below:

1. Because of the possibility of renewing their charters indefinitely, banks may be regarded as endowed with a perpetual existence. This permanency enables them to assume responsibility for the care of property placed in their hands for periods of time much longer than the life of the average individual.

2. This continuity of existence results in a stability of policy and a uniformity of procedure which is impossible of realization when positions of trust are placed in individual hands.

3. Banks have regular places of business, they are open at definite hours, and they are so conservatively managed and carefully inspected that they are not likely to speculate with funds or to sequestrate them.

4. The officers of a bank are usually experienced financiers and therefore are able to handle wisely the funds entrusted to

them. Moreover, because of the large volume of business handled, it is frequently possible for banks to employ specialists in each section of the financial field.

5. The bank as a corporation is impersonal in its relations to those who are beneficiaries under trust arrangements. It acts in harmony with the directions of the creator of the trust and is not moved by pleas or threats.

6. The cautious and conservative handling of fiduciary transactions is insured in many states by the requirement that a bank exercising trust powers shall deposit securities with the state government as a guarantee of the faithful performance of its duties. This provision is sometimes supplemented by laws which specify the character of the investments to be made of funds held in trust.

National Banks as Fiduciary Agents.—In some states institutions which desire to act in the capacity of trustee must take out a special charter. In others, any banks chartered by the state may so act. It is only since the passage of the Federal Reserve Act that national banks have been allowed to act fully in this capacity. An amendment to the Federal Reserve Act, approved September, 1918, gives the Federal Reserve Board power "to grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the State in which the national bank is located." The Federal Reserve Board has the power to grant or refuse permission, but it is subject to this restriction, "that no permit shall be issued to any national banking association having a capital and surplus less than the capital and surplus required by State law of

State banks, trust companies, and corporations exercising such powers."

The purpose of granting to national banks the powers enumerated in the quotation above, is to put the national banks on an equal footing with the state institutions in competing for fiduciary business. It is interesting to observe that, in addition to provisions contained in the original act, amendments have been adopted from time to time for the purpose of strengthening the position of the national banks in competition with state institutions. This policy is part of a general attempt to make membership in the federal reserve system attractive and profitable.

Activities of the Trust Department.—When a national bank has obtained permission to establish a trust department, the board of directors creates by resolution a separate department of the bank, under officers whose duties are prescribed. Two or more officers or employees are designated to have charge of the trust securities, and they must furnish a bond for the faithful performance of their duties. The trust department is thus distinct from the banking department. Its books and records are kept separately from those of the bank, and a separate account is established in which cash trust funds are deposited. If such funds are treated as a general deposit of the bank, United States bonds or other securities to an equivalent amount must be deposited with the trust department. Likewise, securities and all assets other than the cash held in a fiduciary capacity must be kept separately from those of the bank, and the securities and assets of each trust must be kept apart from every other trust. The trust department of a national bank may not receive deposits subject to check, or bills or other items for collection or exchange. No loans may be made to officers or employees of the bank.

Corporate Trusts.—Though trusts are of great variety, a characteristic feature of them all is individual service. A bank

may make an agreement with an individual or corporation to be responsible for almost any kind of a financial transaction. However, for purposes of discussion, trusts may be divided into two main classes: corporate trusts and individual trusts. The term "corporate trust" covers those activities carried on in connection with the financial affairs of a corporation. This work has developed until it covers practically every financial need of a corporation, such as acting as trustee under mortgage and similar agreements; serving as depositary under escrows and reorganizations; acting as paying agent for dividends, coupons, and the principal of bonds and notes; serving as transfer agent or registrar of stocks, bonds, and notes; or finally, as receiver, fiscal agent, or attorney.

In acting for the individual, the trust department assumes responsibility for the care of securities. It also becomes the trustee of voluntary trusts made by a person during his lifetime for a specific purpose, such as the support of a relative, the education of children, or a contribution to charity. In addition, the bank may serve as the executor of a will, as trustee of funds when they have been distributed, as administrator, and as guardian of the property of minors.

The Trust Department as Executor or Administrator.—As executor named in a will, or as administrator of an estate under an appointment of the court at the request of heirs where there is no will, the trust department takes charge of property, files an inventory with the court, pays funeral expenses and other just claims, and finally distributes the property to those entitled to receive it. Inasmuch as the trust department has already deposited security with the state authorities, it is not required to bond itself further as the executor of the will. The estate therefore saves the expense which a personal executor ordinarily would incur in furnishing a bond. If the drawer of a will so desires, he may place the will with the trust department, leaving the bank's

receipt for it among his papers to show that such a document has been executed. As administrator, the bank exercises only the specific powers delegated to it by the court, dividing the estate among the heirs in the proportions fixed by law. After the distribution of the property, the administrator makes an accounting to the court and obtains his release just as does anyone who is serving as executor under a will.

The Voluntary or Living Trust.—A form of trust service which is rapidly gaining in popularity is the voluntary or living trust. Under such an arrangement, the owner of property transfers title to the trustees and instructs the latter how to pay the income and reinvest the funds. The bank collects the income, invests and reinvests the principal, and at stated intervals renders an account to the donor. These trusts are sometimes revocable and subject to change, and sometimes irrevocable and not subject to change, even by the donor himself. The agreement may be so drawn as to make a will unnecessary; or, if only a part of the owner's property is placed in trust, his will need only dispose of the residue. The purpose may be to set aside funds as special gifts or to safeguard funds with a provision for the payment of the income to the owner.

A man who desires to retire from active business may thus obtain the services of men still in close touch with market activities for handling his investments. The creator of a trust may in effect make the trustee a managing partner, and for a small fee may enjoy freedom from financial worry while receiving his usual income. Another development of the trust business is the trusteeship of the proceeds from a life insurance policy. This form of trusteeship is frequently put into effect in order that the proceeds of the policy may be safely and permanently invested for those who are to benefit by them.

Investment of Trust Funds.—The funds received under these various trust arrangements are invested according to the direc-

tions of the will or the trust deed under which they are held, or, in the absence of specific directions, according to state law. Where liberty to make investments is given to the bank, the investments of the trust department are determined usually by a special committee of the board of directors. In most states, as, for example, New York, when no special instructions are given, trustees are requested to invest their funds in securities which are legal investments for savings banks. A list of such securities is prepared at intervals by the state banking department.

When a donor wishes to exempt the trustee from this limitation he states his desire in the will or deed. Frequently he gives very broad powers of investment to the trustee bank, permitting it to retain investments in the form in which the estate or trust is delivered and relying upon it to select suitable securities whenever reinvestments are necessary. Sometimes the trust provides that the donor, if living, shall be consulted as to new investments. Under trusts placed by courts, investments are generally made with the approval of the court, unless the state law specifically enumerates the forms of investments to be made by fiduciaries.

Receiverships.—The trust department may be called upon by a court to act as receiver for concerns which are in financial difficulties. The function of the trustee in this case is to assume charge of the affairs of the concern, and to seek to administer them in such a way as to restore the business to a sound financial basis. In acting as receiver, the bank exercises only the specific powers delegated to it by the court.

Collateral Trusts.—In a few large cities of the country and preëminently in New York, a great part of the trust activities of banks consists in handling a trust created by mortgages made to secure bond issues. In a transaction of this sort, the borrowers transfer to the trustee, for the benefit of the security holders, the title to the property pledged. The property may consist of securi-

ties, real estate, equipment, or other valuable possessions. If the assets pledged consist of securities, the mortgage is spoken of as a collateral trust and the securities are accompanied by a power of attorney, or they are registered in the name of the trustee. When substitutes of collateral are permitted, it is the duty of the trustee to see that the security which guarantees the bond issue remains unimpaired.

Some collateral trust mortgages provide that the borrowing corporation shall maintain a certain margin of collateral. It is the duty of the bank in this case to see that the requirement is met. In handling mortgages other than collateral trusts, the borrowing corporation retains possession of the property pledged so long as it complies with the terms of the trust. In case of default of either type of trust, it is the duty of the trustee to protect the interests of security-holders.

In acting as trustee under mortgages securing bond issues, a bank is required to enforce the provisions of the mortgage as to the delivery of the bonds. The practice varies, of course, with each issue. In some cases it is stipulated that the entire issue of the bonds be delivered at the time the mortgage is recorded. In other cases deliveries are to be made in instalments, either periodically or when certain requirements, such as the completion of specified units of construction, have been complied with. In still other cases the terms of the mortgage require that prior bonds be retired out of the proceeds of the new issue.

Sinking Fund Payments.—Since the trustee in the transactions under discussion represents a large number of lenders who are relying upon the bank to see that their interests are protected, the bank is responsible for enforcing the sinking fund provisions, if any, in the mortgage. The bank must see that the proper amount is set aside at each period and must attend to the disposition of the funds. Sometimes the mortgage provides for the retirement of a part of the bond issue by annual drawings; at other

times the contract permits the trustees to retire a part of the issue at their option. If the agreement calls for the retirement of the issue by periodic drawings, the trustee arranges the drawings by lot and announces the numbers of the bonds called for payment.

When the trustee is authorized to retire bonds at its option, the sinking fund instalments are usually invested in interest-bearing securities to be held for the benefit of the holders of outstanding bonds; or the trustee may purchase in the open market a portion of the issue to be retired. Some mortgage agreements require that bonds be retired serially, while in other trusts and similar mortgages a portion of the bonds are to be retired each year from current earnings. In either case, it is the duty of the trustee to see that the conditions are complied with. When the bonds are paid off, the release of the lien is effected in the place where the mortgage has been recorded, and the bonds which have been retired are destroyed.

Trustee in Reorganization Proceedings.—The trust department of a bank may be called upon to act as the custodian for securities deposited under plans of reorganization. When a corporation defaults in its obligations, it is to the interest of the security-holders that the business be kept intact, and that if possible it be restored to a paying basis. The security of property mortgages is based, not upon the physical value of the property, but upon its value in use by a going concern. It is the custom, therefore, where possible, to reorganize defaulting concerns; the reorganizer adjusts the claims of the various creditors and restores the business to a sound financial standing.

A reorganization committee, consisting of a few of the principal security-holders, is usually formed as the first step in reorganization. All security-holders are then called upon to deposit their holdings in trust, pending the formulation of a reorganization plan or other concerted action to protect their interests. The

trustee delivers temporary receipts for the securities surrendered, to be replaced later by engraved receipts which are negotiable on the exchange where the issue is listed. The trustee bank frequently assists in preparing the plan of reorganization, but its main task is to carry out the provisions of the plan. It collects the assessments levied and, after the plan is completed, it delivers new securities upon the surrender of the trust receipts.

Protecting and Supervising Security Holdings.—Another fiduciary activity of a modern bank consists in safeguarding securities left in its care by customers. The bank assumes this custody in two ways. One of these is the very common plan of installing safe deposit vaults in the bank building and renting space therein to customers, who use it for the safe-keeping of bonds, stocks, and other valuables. The bank merely provides the place for the safe-keeping of valuables and collects a fixed rental.

The second method is for the bank to assume the responsibility, not only of keeping the securities, but of giving them personal attention. For example, the bank may clip coupons and collect interest on bonds left in its care. The bank also takes note of any developments which may affect the value of the securities and advises the owner regarding such matters; for example, conversion privileges, the granting of rights to subscribe to new stock, bankruptcy proceedings, bonds called for retirement, and so forth.

This type of bank business has grown in importance in the United States since the ownership of securities has become more general through the flotation of the Liberty bonds. Many persons are now interested in renting safe deposit vaults, and many are willing to pay a small fee to have a reliable bank look after the collection of income from their investments. The service in the case of many banks also includes the purchase and sale of securities on behalf of its customers.

Advantages to Customers of Securities Service.—The advantages which accrue to customers from the use of a bank's securities service are as follows:

1. The bank has special fire-proof and burglar-proof vaults in which the securities are kept.

2. If the customer wishes to negotiate a loan, he can do this the more conveniently inasmuch as some of the preliminaries to borrowing upon his securities have already been complied with. For example, the securities are in the possession of the bank; they have been examined and approved as "good delivery" upon the exchange and can be transferred readily from the customers' security department to the loan department if the loan is authorized.

3. By leaving his securities in the hands of a bank and in "good delivery" condition, the customer can sell when he desires with the least possible delay.

4. The customer is not only saved the trouble of looking after coupons and the collection of dividends, but he enjoys the convenience and advantage of information about changes affecting the value of his securities of which he might not otherwise learn for some time. The bank makes use of the daily papers and financial publications for notices of the calling of bonds, reorganizations, receiverships, issues of new shares of stock, and expiration of conversion privileges.

The Security Nominee.—When securities are committed to the complete care of the bank, it is sometimes the custom to have them registered in the name of one of the officers or employees of the bank who is placed in charge of them. This person is termed the nominee, and he is to all intents and purposes the owner of the securities. Shares of stock are transferred to his name and bonds are registered in his name. He has full power to transfer title, to collect income, and to exercise any rights that the actual owner would be able to exercise. The bank can thus perform all

the routine functions of collecting income without troubling the owner. In selling, or exercising any rights, the customer can communicate with the bank and his orders are executed promptly. In the practice of large city banks, the bulk of the securities held in this manner are those kept for the account of correspondent banks, who in turn are acting in behalf of their customers; in the majority of cases the city bank does not know the identity of the actual owners of the securities.

Security Records.—The bank exercises the same care with respect to securities belonging to customers as it does in handling its own holdings, and it carries out the instructions of its depositors literally. When securities are received, the date of the transaction is recorded and the name of the security, the amount, the name of the depositor, and the instructions concerning the handling of the item are all carefully noted. A receipt is given which specifies exactly what the depositor may claim. This receipt serves as a means of identification and must be presented before the securities will be returned. While the securities are in the bank's hands, all transactions regarding them are accurately recorded, and they are removed from the bank only upon the explicit instructions of the owner. The customer may desire the return of the securities, may order the bank to sell them, or may request that they be delivered to a broker or bond house for sale. In any case, the instructions are followed, and the authority for the bank's action is filed with its records. Care is taken to make sure that the signature of the letter of instruction corresponds with the owner's signature.

Payment for Fiduciary Services.—The fees charged by the bank for the above fiduciary services vary widely according to their nature and extent. When a bank is appointed by the court to act as trustee, the compensation to which it is entitled is fixed by law as follows: For receiving and paying out all sums of

principal not exceeding $1,000, at the rate of 5 per cent. For receiving and paying out any additional sums of principal not exceeding $10,000, at the rate of 2½ per cent. For receiving and paying out all sums of principal above $11,000, at the rate of 1 per cent. If there is more than one trustee and the amount involved is less than $100,000, the commission at the usual rate is divided equally among the trustees. On larger amounts each trustee is entitled to full legal fees providing there are not more than three trustees. One-half of the commission is payable when the principal is placed in trust, and the remainder when it has finally been paid out and the trust is completed. Fees for other services, such as the keeping of securities, preparing income tax certificates, reinvesting funds, and furnishing special information, vary according to agreement.

CHAPTER XXIV

THE BANK AS REPRESENTATIVE OF CUSTOMER

Banks as Business or Personal Representatives.—Anothei supplementary activity which is characteristic of large banks is that of acting in a representative capacity. Because of their strategic position at the centers of trade, because of the employment on their staff of men who are expert in matters of trade and finance, and because they have the machinery and the reputation requisite for the successful handling of trusts, banks are sometimes called upon to act in the capacity of business representatives—and sometimes personal representatives—of individuals and corporations. While banks frequently act as representatives for individuals in a great variety of transactions, the bulk of such business arises from the needs of corporations.

A corporation with a large number of stockholders and bondholders and with large financial transactions to put through, frequently finds it impracticable to maintain an organization exclusively for the purpose of handling its financial relations with its security-holders. Furthermore, the purchasers of the bonds or other obligations of a corporation desire the intervention of a disinterested party in their relations with it. They want some guarantee other than the word of the corporation officials, that the terms under which the money is advanced are being complied with, and they desire especially some assurance of the validity of the securities they contemplate purchasing. Finally, it should be noted that the holders of the securities are numerous and are scattered throughout the country and even throughout the world. Since they are not in touch with each other, and there is therefore no possibility of mutual counsel and unity of action to protect their interests, it is advisable to obtain some one reliable agency

which is able to do this for them. It would be very difficult if not impossible for a corporation to market its securities on a wide scale if buyers were not assured that their interests would be looked after adequately by a responsible bank. Hence, the corporation is as eager to secure a well-known bank to act as the representative of those who may purchase its securities as are the security-holders themselves.

The bank thus acts in the twofold capacity of representative for both the corporation and individual holders of its securities. This service is represented by three forms or lines of activity. The bank may act, first, as transfer agent for corporations; secondly, as registrar; and thirdly, as fiscal agent.

Transfer Agent.—In acting as transfer agent for a corporation, the chief duty of the bank is to look after all routine matters connected with transferring the ownership of shares of stock in the corporation. Ownership of stock is represented by certificates which may be drawn up for any number of shares. In transferring ownership the seller executes an assignment which is prepared in blank on the back of the certificate. This states that the number of shares specified therein are to be transferred to the party named in the assignment, and authorizes the corporation to transfer ownership on its books. The certificate with its assignment indorsed is sent to the corporation, and the transfer is made by drawing up a new certificate in the name of the new owner and changing the name of the owner on the books of the corporation. The old certificate is canceled.

Need for Transfer Facilities.—It is customary for most corporations, particularly the smaller ones, to act as their own transfer agents. In the buying and setting of the shares of larger corporations whose securities are actively traded in on the New York Stock Exchange, a large number of transfers arise in the course of a year. For convenience in making these transfers

quickly, some corporations maintain their own transfer agencies in the financial district of New York. Other corporations, however, do not consider it economical to maintain an office and a force of clerks for this purpose, but prefer to designate some financial institution to handle such matters for them.

Stock Transfer Records.—When a bank is appointed transfer agent for a corporation, it becomes the custodian of the stock transfer book and the stock ledger, together with a supply of blank stock certificates of the corporation. The certificates are numbered consecutively and are signed by the proper officers of the corporation before they are delivered to the transfer agent. They are not valid, however, unless countersigned by the transfer agent and the registrar. It is the duty of the transfer agent to pass upon the regularity and legality of the assignment of the title to the certificate, to enter a record of the transfer on the books of the corporation, to cancel the old certificate, and to execute and deliver the new certificate in its stead.

Information Required by Transfer Agent.—Certain information must be filed with the transfer agent regarding the corporation and its issues of stock. This includes a certified copy of the charter, certified minutes of the corporation and meetings of the incorporators, a certified copy of the by-laws, certified copies of all votes of stockholders and directors authorizing stock issues, a certificate from the treasurer that the stock is fully paid, a copy of the form of stock certificates issued, the vote of the directors approving this form, their votes appointing the transfer agent and the registrar, and a certified list of the officers and directors of the corporation, with their signatures.

When a certificate of stock is received for transfer, it is examined to make sure that the transfer can be made legally. The genuineness of the document is established by the signatures of the proper officers of the issuing corporation, the transfer agent,

and the registrar. The assignment on the reverse side of the certificate is examined to make sure that it has been properly executed. If the name of the assignee is not known to the bank, his signature is usually guaranteed by a bank or broker who is known to the transfer agent. Care is also taken to see that the proper number of revenue stamps are attached to the stock certificate or to an accompanying bill of sale; and that no "stop" orders have been lodged against the transfer. In the event of the loss or theft of a stock certificate, its owner may stop transfer or transfer may be stopped by order of the court.

Issue of Stock Certificates—Stock Ledger.—To replace the surrendered certificate the transfer agent issues a new one, using from its supply of blank certificates the one bearing the lowest serial number. This is submitted to an officer of the bank and to the registrar of the issuing company for their signatures. The corporation is kept advised by frequent reports of the transfers made by its agent.

In a stock ledger kept by the transfer agent are recorded the name of each stockholder of the corporation, the amount of his holdings, his address, and instructions for the disposition to be made of his dividends.

Dividend Payments.—In some cases the bank as transfer agent may pay the dividends which are declared upon the stock of the corporation. If the bank is engaged to do this, the corporation deposits with it a sum sufficient to meet the dividend requirements. The bank makes out and mails the checks to the shareholders recorded on the list of corporation stockholders. In other cases the transfer agent prepares the list of the shareholders and the number of shares held by each, and sends this to the corporation just before the dividend checks are to be made out. The corporation itself then attends to the work of preparing and mailing the checks.

Subscriptions to New Stock Issues.—When a bank acts as transfer agent for another corporation, it is sometimes called upon to receive subscriptions for increases in the capital stock of the corporation. If these subscriptions are payable in instalments, as frequently happens, the bank accepts the payments, and keeps an accurate record of each shareholder's subscription payments and the amount remaining unpaid. When payment is completed a certificate for the shares purchased is issued.

Registrar for Corporations.—Another representative function performed by a bank is that of acting as registrar. The purpose of a bank acting in this capacity is to assure the validity of security issues by having some disinterested party exercise control over the amount of an issue and the circumstances under which it is made. The supervision furnished by the transfer agent is largely to protect the corporation against fraudulent transfers and forgeries. The public is interested in knowing that stock certificates and bonds are issued strictly in accordance with the legal powers of the corporation concerned. The registration of stock by a disinterested party is essential to the validity of securities traded in on the New York Stock Exchange.

Main Functions of Registrar.—It is the duty of the registrar of a corporation's stock to see that the amount of stock issued does not exceed the amount legally authorized. Careful supervision is exercised to see that for every new share issued an old one is canceled. In the case of an increase in capitalization, of course, each new share issued must be balanced by the receipt of an equivalent amount of value. A bank may not act as both registrar and transfer agent for the same corporation, inasmuch as the work of the registrar is designed to act as a check upon the work of the transfer agent. However, many banks act as transfer agents for one group of corporations, and as registrars for a different group.

Considerable work for the registrar arises in connection with the issue of corporation bonds. Such securities are of two kinds, registered and coupon. Coupon bonds are payable to bearer, and the coupons themselves can be cashed by anyone. The owner of the bonds collects his interest by detaching and presenting for payment the coupons as they mature. The registered bond differs from the coupon bond, in that title to the bond and to the interest is passed by transfer on the books of the corporation in the same way that the ownership of stocks is transferred. Interest due on a registered bond is paid by check and sent to the registered holder.

Some bonds are registered as to principal only. In this case title to the principal of the bond is passed by a transfer on the books of the corporation, whereas interest is paid by means of coupons.

Bond Transfers.—When a bond is presented for registration or for transfer, the former owner indorses on it a power of attorney or assignment similar to that found on the back of a stock certificate. The security is then submitted to the registrar to have the ownership transferred on its books. In making the transfer, new bonds are not always issued. The old bond is sometimes returned to the purchaser with the change in ownership indicated merely by the indorsement of the bank thereon, the record of the date of registration, and the signature of the official of the bank who is acting as registrar. The bank, of course, keeps a careful record of the bond numbers, and, if coupon bonds, the number of the coupon next due; of the names and addresses of all registered bondholders to whom interest is to be sent; the dates on which the bonds have been transferred from one person to another; and the total amount of bonds registered for each holder.

Interest Payments by Registrar.—As in paying dividends, so in paying interest, the registrar may either receive from the

corporation a lump sum out of which to make payments to the bondholders; or it may furnish the corporation with a list of the registered bondholders and the corporation itself may mail the interest checks. If the bank mails the interest checks, it requires that a properly executed income tax certificate be filed with it by each bondholder. To facilitate this matter, a letter is mailed at a convenient interval before the interest is due, enclosing the proper certificate and requesting that it be duly executed and returned to the bank before the date on which the interest is due. This formality is necessitated because of the fact that the law requires the income tax in such cases to be deducted at the source.

The Bank as Fiscal Agent.—Another rôle in which banks act as representatives for corporations is that of fiscal agent. In the investment world every day large numbers of coupons fall due for payment, and dividends and interest need to be paid on the securities held by investors. The corporations responsible for these payments are scattered in various parts of the world, but for the convenience of investors a large number of the obligations are payable in New York. Banks in all parts of the world accept and cash such claims, sending to New York for reimbursement the coupons, checks, and bonds as they mature.

To meet these obligations, the larger debtor corporations and governments may operate their own paying offices at a few main centers. For the convenience of the investing public, however, it is the practice for a large corporation to appoint as its fiscal agent a bank or trust company located in the financial district of New York. A contract is made between the corporation and the bank, whereby it is agreed and announced that payments will be made by the bank for the account of the corporation. The funds needed for making payments may be deposited in a special account, or the bank may be authorized to charge the matured bonds and coupons to the regular deposit account of the corporation. The bank obtains a specimen or detailed description of the

bonds issued, together with a copy of the signatures appearing therein. These records enable it to determine the validity of the bonds and the coupons presented for payment.

Coupon Payments.—When bond coupons are payable at any bank, they are returned to the bank which acts as fiscal agent, enclosed in a particular style of envelope furnished by the fiscal agent. The envelope shows the name of the issuing company, the number and amount of the coupons enclosed, and the total amount. Coupons are carefully counted and examined to see that the amount enclosed agrees with the total on the outside of the envelope, that they are due, that the proper ownership certificate is attached, and that no stop payment orders have been lodged against them. The payment of coupons may be stopped when the bonds to which they have been attached have been lost or stolen.

As the paid coupons accumulate they are charged to the account of the corporation, and transferred to larger envelopes, on the outside of which appears a list of the contents. Finally they are returned to the debtor corporation just as paid checks or vouchers.

Fiscal Agents and the Collection of Income Tax Payments.—As already indicated, the income tax law of the United States imposes upon the paying agent the task of seeing that the recipients of income from corporations pay the required tax. This tax burden is sometimes assumed by the corporation although the assumption of the burden is optional. However, to make an issue more attractive the bonds are often sold tax free, the debtor corporation paying the tax at the rate of 2 per cent on the bond income. It should be noted that corporations, governments, and municipalities domiciled outside the United States are not permitted to assume this normal tax.

In collecting the income from a tax-free issue of securities, the

owner indicates, by the use of a special form of income tax return, whether or not he is exempt from the federal income tax. If he claims exemption the corporation does not need to pay any tax for him. If he does not claim exemption, the debtor corporation pays the owner through the fiscal agent in full for his coupons, and in addition it pays the government 2 per cent of the amount paid to the owner. When the owner of such securities pays his income tax, he is permitted to deduct, from the gross amount of taxes due, this 2 per cent which was paid for him at the source.

A corporation may delegate to the bank acting as its fiscal agent the task of handling income tax deductions, and this is frequently found convenient. The bank then determines from the ownership certificates filed with it, the amount to be paid to the government; and each month it makes the requisite disbursement to the government. From time to time the fiscal agent forwards to the Treasury Department the ownership certificates received from those subject to the tax. The Treasury officials are thus enabled to account for the taxes paid at the source, and to check up the returns of individual taxpayers to see whether any have claimed exemption who are not entitled to it.

Compensation for Services.—The compensation of the bank for its services as registrar and transfer agent is determined by contract agreement. Sometimes the contract specifies a payment for each certificate registered and for each transfer. When a bank acts as fiscal agent, its compensation sometimes takes the form of a small commission on the interest payments made. Frequently the parties to these arrangements enter into a yearly contract by which, for a fixed total sum, the bank agrees to do all the work required but with an allowance of special fees for work requiring special attention, such as the issue of two $50-share certificates for one of $100, or the special work of making a transfer and getting out the new certificate on the same day. In addition to such compensation as may be agreed upon, the corporation bears

the cost of engraving and providing new certificates and pays the expenses for stationery and postage.

Service in Import and Export Trade.—A bank which has customers located in various parts of the world is frequently called upon to act as their representative in the exportation and importation of merchandise. The bank may, for instance, receive and care for goods shipped, collect insurance claims, make payments on ships under construction, and undertake collections of irregular character. Only a few of these services need here be considered.

Custom house procedure requires that import shipments be claimed immediately upon their arrival in port; otherwise the goods are seized and stored by the government with a resultant heavy charge upon the shipper. To avoid this expense a bank, acting as the representative for a foreign shipper, engages a custom house broker to look after the clearing of the goods. When the broker has cleared the goods, he delivers the warehouse receipt to the bank, which then has the goods insured against all risks. Sometimes the broker is employed to insure, forward, and even sell the goods.

It should be noted that the necessity for holding and storing imports, as described above, arises most frequently when the consignee does not promptly pay the draft without which he cannot get possession of the goods. Delays in the payment of drafts drawn against shipments of goods occur for reasons of a temporary nature: the drawee may wish to examine the merchandise before making payment; or there may be some irregularity in the papers or in the merchandise which he desires to have corrected. The bank may in such case allow the drawee the time desired for paying the draft. When the bill is finally settled the bank gives a delivery order to the drawee and he obtains possession of the goods. If the bill is not paid, the bank, at the shipper's request, may institute legal proceedings against the drawee.

Sometimes clients consign shipments of merchandise direct to a bank, to be held until the client can dispose of them to the best advantage. Documents made out in the name of the bank are transmitted to the broker, who enters, stores, and insures the goods in the usual manner. The shipper then proceeds to sell the cargo in whole or in part. If he desires, the bank assists him in this sale by keeping him advised as to the state of the market and by having his orders executed promptly.

If a shipment consists of perishable or seasonable goods and if the documents which must be presented to obtain delivery have not arrived, the bank, as representative for the shipper, may protect his interest by furnishing to the customs official guarantees of indemnity, and thus may have the goods delivered so that they can be disposed of.

Bail Bonds.—Occasionally a bank is requested to have surety companies write bail bonds for the accounts of clients. These requests may originate in the following manner: the law provides that ships which have been libeled for damages arising out of collision, fire, or some other accident, shall be released for the benefit of the owners as soon as possible. In lieu of the ship or cargo some other security must be provided. The customary method of providing such security is by means of a bail bond written by a surety company on behalf of the ship-owner. Under such a bond the surety company agrees to pay any amount which may be later adjudged to the plaintiff by the court.

Special Services for Foreign Clients.—Foreign clients often have occasion to make payments in the United States, under conditions which require a trustworthy local agent to determine when and to what extent the conditions have been fulfilled. Many such transactions have arisen within recent years in connection with the purchase by foreign shipping companies of vessels built in the United States. Payments may be made on

ships under construction by instalments advanced as the ship reaches various stages of completion. In this case the bank, through its representative, makes payment for the account of its client as the conditions are complied with. Sometimes payments are made for the purchase of vessels already constructed. The bank, acting as representative in this case, delivers the money only when the proper documents evidencing ownership and registry are delivered in accordance with the purchaser's instructions.

CHAPTER XXV

ADVISORY FUNCTIONS

The Bank as a Business Consultant.—A third activity in which banks engage but which is not strictly speaking a banking function consists in serving their customers in an advisory capacity. The prosperity of a bank is wholly dependent upon the volume of business handled by its clientele. Realizing this, bankers are constantly on the alert to further the interests and assist in extending the business of the bank's depositors in every legitimate way. Efforts in this direction are not confined to the activities of any one department or any group of departments. Each department, and indeed the whole administrative force of the bank, seeks to furnish advice and assistance of a legitimate kind to depositors, on request. The bank officials are ready to meet their customers for consultation and to give them the benefit of any information which directly or indirectly will help them in their business.

The banker in the small town is called upon very frequently for his advice, and the subjects on which he proffers counsel range all the way from methods of financing the purchase of a house to the settlement of domestic relations. In fact, the whole effort of progressive banks, whether in small towns or large cities, is directed toward giving their customers the most helpful service possible. It would be impossible, even if desirable, to discuss in detail the many kinds of service that a bank can render to its clients. It is, however, desirable to consider certain recent developments in this direction among the larger banks of the metropolis.

Recent Activity in Foreign Trade.—One of the most interesting and promising phases of modern banking activity is connected

with the development of foreign trade. During the years immediately preceding the war, and especially since the war, there has been a great awakening of interest on the part of American manufacturers and merchants in the possibilities of foreign trade. Nevertheless, there are still many American traders who are unaware how to obtain foreign credit information, how to select suitable foreign agents and representatives, and where to look for the proper channels of distribution for their special products and for information as to the best method of packing and shipping their goods and financing their business.

A large bank with international financial connections is in a position to procure all such information and to give invaluable advice to its customers concerning trade in foreign fields. Some of the more important metropolitan banks make special efforts to obtain the services of experts in foreign trade, and to devise means to bring their clients in this country into touch with opportunities abroad of which the latter might otherwise remain in ignorance.

The Foreign Trade Department.—To give this advisory service, one of the large banks in this country maintains an international trade staff, which is divided into two sections, domestic and foreign. The domestic section is subdivided according to federal reserve districts. For each part of the country a thorough study is made, both of the products which it contributes to our export trade and of the demand which exists, or may be developed abroad for its commodities and manufacture. The foreign section of the international trade staff is composed of men of foreign birth who have had extensive commercial experience abroad and who are therefore thoroughly acquainted with the customs, psychology, and commercial life of foreign peoples. These men, known as consultants, are assigned the study of the chief commercial cities of the countries with which they are most familiar. Through their work, the foreign department is enabled to make an

intensive study of commerce and industry in every part of the world.

Foreign Branches and Trade Reports.—In addition to its foreign representatives, the bank referred to has a considerable number of foreign branches. These branches may be regarded as outposts of American interests in foreign fields. Each foreign branch has a special trade representative who devotes his entire time to studying trade conditions and searching for business opportunities in his particular district. Four reports to the home office are made by these representatives. One of these is a commercial report, which deals with trading concerns; another is an industrial report, which deals with manufacturing establishments; a third is a trade report, which covers the field by commodities; and a fourth handles miscellaneous matters, such as trade legislation, trade-mark laws, customs and tariffs, general shipping news and facilities, public works, and the names of firms or individuals qualified to act as agents for domestic concerns. In addition to their regular reports the branches send any available information about trade opportunities.

Dissemination of Information.—One of the main functions of the foreign trade department is its publicity work. It collects the reports from the representatives stationed abroad, analyzes them, and combines them for distribution. The dissemination of information thus gathered is effected by the publication of a foreign trade bulletin, by replies to letters of inquiry, and by interviews. In these ways opportunities for American business houses in foreign markets are brought to the attention of the bank's customers. In the bulletin, for instance, are listed the names of foreign visitors who are in this country to make business connections, and also the names of persons desiring to represent American concerns abroad or those seeking representation in the United States. Here also are published reports and information

in regard both to specific products and to topics of general interest to exporters and importers.

Individual Service to Correspondents.—The bank's correspondents are encouraged to write for information on matters relating to foreign trade. If necessary, their letters are made the subject of special investigation. No trouble is spared to get the latest reports covering the information sought, and the bank's branches, traveling representatives, and correspondents in all parts of the world are called upon to comply with any request for data. The same sort of service is given to those who call in person to discuss their problems with members of the foreign trade department. The information given varies from the definition of technical terms, to advice as to the best method of organizing an export department or of packing merchandise.

Service to Travelers.—The bank makes a specialty of aiding American visitors in foreign countries, as well as foreign visitors in America. To Americans who desire to go abroad, valuable information is given by the employees who are familiar with conditions in the countries of destination because of long residence there. Letters of introduction to branches, correspondents, and customers of the bank are readily provided and clients are urged to make use of the facilities thus afforded.

Similarly, foreign clients who visit this country find the bank eager to render service. In the foreign trade department, the visitor is greeted by an employee who speaks his language and understands his business methods and point of view. If he has a product to market in the United States, every effort is made to put him in touch with the bank's customers throughout the country who may be interested in his offer. The domestic section of the foreign trade department is called upon to suggest in which part of the country the demand is likely to be greatest for the

particular commodity the foreign visitor has for sale, and he is urged to make use of the facilities of the bank. If he desires to travel in the United States, letters of introduction to domestic correspondents and customers of the bank are furnished him.

Foreign Language Directories.—Besides these specific services to individuals, the foreign trade department of the bank offers certain general services to all alike. A directory has been prepared in several foreign languages for circulation in the countries using these languages. This directory contains a list of all the business houses which the bank numbers among its domestic customers, and a list of the chief products of the United States with the names of the firms dealing in them. With reference to each concern mentioned are given the cable address of each concern; the codes it uses for cablegrams; the date of its establishment; its capital and surplus; the names of its agents abroad, if any; the products dealt in; and a statement as to whether or not it does an export and import business.

Foreign Trade Conventions.—Another activity of the foreign trade department is to attend all important conventions and gatherings where matters relating to foreign trade development are discussed, with the object of tendering the information which is sought there by people from all parts of the country. These services, while primarily designed for customers, are given freely to others. The bank's aim is to aid in the up-building of domestic and international trade.

Individual Service.—Some large banks are now acting as advisers to clients in regard to special problems, for which work what is termed an industrial service department has been organized. The personnel of the department consists of experienced industrial engineers, who travel about the country making sur-

veys of the organization and plants of industrial concerns which are either customers or prospective customers of the bank. Such inspection serves two purposes: the bank acquires valuable credit information, and the customer is proffered definite suggestions for the improvement of his business. The results of the surveys are embodied in comprehensive reports submitted alike to the bank and to the client.

The factors which determine the credit standing of a large manufacturing concern are so varied and so intangible that they cannot be fully presented on a balance sheet or a profit and loss statement. Some of the most important of these factors are the location of the industry with respect to raw materials, labor supply, and markets; the industrial conditions in the plant; its methods of management; the system of cost accounting in vogue; the price at which the product sells; the strength of competition; and so on. It is part of the work of the industrial service experts to obtain and interpret such facts for the guidance of the credit department of the bank.

Service to Others than Customers.—The work done by the industrial engineers serves a far more important purpose, however, than merely to collect information for the bank's credit department. Their investigations are made primarily for the purpose of tendering advice and assistance. Hence they sometimes survey plants of concerns which do not need bank credit or which are not customers of the bank. The long experience of these experts in the industrial field enables them to analyze almost any type of business and make suggestions for its improvement. As a result of these investigations, the industrial service department has accumulated valuable data for each industry, covering cost of production and the elements making up this cost, profits, and similar information.

In addition to furnishing individuals with special advice about their business problems, the industrial service department fre-

quently performs a service of more general nature. This service takes the form of the publication of studies and reports on the common problems of manufacturers, which reports are distributed by the bank's publicity department.

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